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No. 23

In the Supreme Court of the United States

OCTOBER TERM, 1960

KARL F. KNETSCH, ET AL., PETITIONERS

v.

UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

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BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The District Court rendered an oral opinion. (R. 103–104.) Its findings of fact and conclusion of law (R. 55–61) are not officially reported. The opinion of the Court of Appeals (R. 111–112) is reported at 272 F. 2d 200.

JURISDICTION

The judgment of the Court of Appeals was entered on November 16, 1959. (R. 113.) The taxpayers filed the petition for a writ of certiorari on December 21, 1959, and it was granted on February 23, 1960. (361 U.S. 958; R. 114.) The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the lower courts erred in holding that so-called prepayments of interest on so-called annuity contract loans did not represent "interest * * * on indebtedness" within the meaning of Section 23(b) of the Internal Revenue Code of 1939 or its successor, Section 163(a) of the Internal Revenue Code of 1954, and hence were not deductible in the computation of the taxpayers' net income.

STATUTES INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *
>
> * * * * *
>
> (26 U.S.C. 1952 ed., Sec. 23.)
>
> SEC. 24. ITEMS NOT DEDUCTIBLE.
>
> (a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—
>
> * * * * *
>
> (6) [Added by Sec. 129 of the Revenue Act of 1942, c. 619, 56 Stat. 798.] Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid

within a period of four years from the date on which such contract is purchased, such contract shall be considered a single premium life insurance or endowment contract; * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 24.)

Internal Revenue Code of 1954:

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * * *

(26 U.S.C. 1958 ed., Sec. 163.)

SEC. 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.

(a) *General Rule.*—No deduction shall be allowed for—

* * * * * *

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954.

* * * * * *

(26 U.S.C. 1958 ed., Sec. 264.)

STATEMENT

The material facts, as found by the District Court (R. 55–59), as admitted by the parties (R. 37–43), and as they appear from certain exhibits of record (printed in Appendix A, *infra*, for the convenience of this Court), may be summarized as follows:

The taxpayers, husband and wife, filed their joint returns for the taxable years 1953 and 1954 on the cash basis. (R. 37, 55.) On December 11, 1953, ten "annuity savings bonds" were issued by the Sam Houston Life Insurance Company of Houston, Texas, in the name of the taxpayer-husband (hereafter called the taxpayer). The stated consideration for the issuance of each annuity bond was $400,400, of which only $400 was to be paid in cash. Each bond recited that it was issued in "consideration of the payment in advance of a single premium of $400 in cash, and the execution of a contract loan agreement for $400,000." Concurrently, as required by the bonds, the taxpayer executed ten "annuity loan notes and assignments of annuity savings bonds," each in the sum of $400,000, for an aggregate of $4,000,000, and gave Sam Houston his check for $4,000 to cover the cash payments of $400 per bond. The annuity bonds and the loan notes were integrated documents which referred to each other. The annuity bonds, rather than the loan notes, specified that the rate of interest on the "loans" totaling $4,000,000 should be 3½ per cent annum, payable in advance. It was also provided in the annuity bonds themselves, as well as in the loan notes, that they were assigned to Sam Houston as security for the "loans." (R. 56; Ex. 3, Appendix A, *infra*, pp. 57, 64, 69; Ex. 13, Appendix A, *infra*, pp. 69–70.)[1]

[1] The cited exhibits constitute, respectively, one of the ten identical annuity bonds and one of the ten identical loan notes here involved.

Each of the loan notes (Exhibit 13, Appendix A, *infra*, pp. 69–70) provided that the "loan" of $400,000 evidenced thereby should be applied by the Company to pay the "remaining premiums" required by the terms of a specifically numbered annuity bond in the name of the taxpayer; and that, in consideration of such "loan", the taxpayer assigned the annuity bond and all sums of money then or thereafter to become due under such bond to the Company as security for repayment of the "loan" and "interest" thereon. Each note further provided that the "interest" on the "loan" should be payable in advance at the rate and in the time and manner provided in the annuity bond, and that the principal of the "loan", together with any accrued "interest", should become due and payable at the same time that the annuity bond should become due and payable. Finally, each note provided: "It is understood that there is no personal liability upon the makers of this note for the payment thereof, the sole recourse being against the said Annuity Savings Bond." Likewise, each of the annuity bonds (Exhibit 3, Appendix A, *infra*, p. 64, par. 11) provided that Sam Houston would make loans on the "sole security" of such bond.

The District Court found that the taxpayer did not receive $4,000,000 from Sam Houston for any purpose. (R. 56.)

Also on December 11, 1953, and concurrently with the execution of the loan notes, the taxpayer paid Sam Houston $140,000, an amount equal to 3½ per cent of the total principal amount ($4,000,000) of the

loan notes. Five days later, on December 16, 1953, Sam Houston returned to the taxpayer a check for $99,000. At the same time he executed ten additional loan notes totalling $99,000, thus augmenting his "indebtedness" to Sam Houston from $4,000,000 to $4,099,000. The taxpayer then, at or about the same time, gave Sam Houston his check for $3,465, a sum equal to 3½ per cent of $99,000. (R. 38–39, 57.)

A year later, on December 27, 1954, the taxpayer paid Sam Houston $143,465, and received in return from the Company a check for $104,000. The ten loan notes totalling $99,000 were canceled and ten new ones were executed by the taxpayer on December 30, 1954, totalling $203,000, thus augmenting the taxpayer's "indebtedness" to $4,203,000. The taxpayer then paid Sam Houston an additional $3,640, an amount equal to 3½ per cent of $104,000. (R. 57.)

On December 28, 1955, the taxpayer paid the company $150,745; received the company's check for $104,000; and executed and delivered new "annuity loan notes" totaling $307,000, in lieu of the old notes totalling $203,000; which were canceled, thus augmenting the taxpayer's "indebtedness" to $4,307,000. (R. 40.)

On December 27, 1956, the taxpayer surrendered the ten annuity savings bonds and received therefor a check for $1,000, together with a cancellation of his alleged "indebtedness," as of that time, of $4,307,000. (R. 40–41.)

While the taxpayer was obligated under the terms of the annuity bonds and the loan notes to pay annual "interest" in advance on the "loan" of $4,000,000 (as augmented periodically) at the rate of 3½ per cent

per annum, the annuity bonds increased in "cash value" at the rate of only 2½ per cent per annum, compounded annually. Sam Houston's profit in the transaction was the difference between the 3½ per cent received and the 2½ per cent paid. (R. 57–59.) Over 99 per cent of the reserve carried by Sam Houston on its books for the years 1952, 1953, and 1954, was for similar 30-year single premium deferred annuity savings bonds. (R. 42.) Prior to entering into the transaction, the taxpayer had been solicited by direct mail advertising from Sam Houston, which recited that a substantial tax saving could be achieved by the purchase of such bonds. In addition, Sam Houston had so advertised in financial newspapers with regularity. (R. 56–57.)

The taxpayer was 60 years old at the time he "purchased" the annuity bonds. Although the bonds were described as 30-year deferred annuities having an "original maturity date" when and if the taxpayer reached 90 years of age, it was also provided that the taxpayer could elect to accelerate maturity at any time. If the maturity date were so accelerated, the amount of the annuity payments would be adjusted in accordance with the "net cash value" of the bonds as of the acceleration date. (R. 58; Exhibit 3, Appendix A, *infra*, p. 58.)

Each of the annuity bonds provided that it had a so-called guaranteed cash value of $838,800 at maturity (that is, if kept in force for the full 30-year period), with monthly annuity payments to the taxpayer, after maturity, of $9,017.10. However, each bond further

provided that the "net cash value" thereof, at any time, should be its cash or loan value less the amount of any indebtedness to the Company against the contract. (Exhibit 3, Appendix A, *infra*, pp. 55, 66.) Thus, had the taxpayer continued to hold the bonds to full maturity (that is, until he was 90 years of age), and had he continued to execute loan notes each year for the total net cash value of the maturity bonds minus $1,000, he would have received on maturity an annuity of only $43 a month. (R. 42.)

The annuity bonds contained no insurance element whatever. (R. 58.) Each annuity bond provided that, if the taxpayer were to die before the maturity of the bonds and the bonds were in full force and effect, the death benefit payable to his designated beneficiary should be "a sum equal to the cash payment made by the Annuitant, excluding any portion of the premium paid by a Contract Loan Agreement, * * * but in no event a sum less than the Cash Value of this Contract, less any indebtedness hereon * * *." (Exhibit 3, Appendix A, *infra*, p. 60.)

On their 1953 return, the taxpayers claimed as a deduction the sums of $140,000 and $3,465, purportedly paid as interest to Sam Houston during 1953. On their 1954 return, the taxpayers claimed as a deduction the sums of $143,465 and $3,640, purportedly paid as interest to Sam Houston during 1954. (R. 39.) The Commissioner having disallowed

the claimed deductions, the instant refund litigation ensued.

The District Court found as ultimate facts that no money or equivalent economic benefits were actually advanced by Sam Houston to the taxpayer; that no true indebtedness was created or intended to be created by the transactions described above; and that no interest was paid by the taxpayer to Sam Houston in 1953 or 1954. Noting that the annual "interest" which the taxpayer was required to pay on the "annuity loan notes" was higher than the annual increase in the cash value of the bonds, and that the bonds contained no insurance element whatever, the District Court further found that the disputed transactions were devoid of commercial substance, constituting only an attempt to purchase interest deductions. (R. 57–59.)

The Court of Appeals noted that the same issue has been presented to the Fifth Circuit in *United States* v. *Bond*, 258 F. 2d 577, which was decided in favor of the taxpayer (Judge Wisdom dissenting), and to the Third Circuit in *Weller* v. *Commissioner*, 270 F. 2d 294, which was decided in favor of the Government. Expressing agreement with the opinion of the Third Circuit in *Weller*, Appendix B, *infra*, pp. 75–86, it affirmed the judgment of the District Court. (R. 112.) [2]

[2] The Second Circuit has since followed the Third Circuit's decision in *Weller* and that of the Ninth Circuit in the instant

SUMMARY OF ARGUMENT

1. Section 23(b) of the Internal Revenue Code of 1939 and the successor provision of the 1954 Code authorize a deduction from gross income of "interest * * * on indebtedness." This Court has repeatedly held that Congress used that phrase in its "usual, ordinary" sense, namely, as denoting "the amount which one has contracted to pay for the use of borrowed money"; and that "an obligation is not necessarily an 'indebtedness' within the meaning of § 23 (b)." See, *e.g.*, *Deputy* v. *DuPont*, 308 U.S. 488, 497–498.

We do not argue in this case that a taxpayer is precluded from minimizing his tax liabilities or that he may not so arrange his affairs as to achieve tax savings. We do contend, however, that the Commissioner may examine the realities of a transaction and that he is not bound to give effect to purely formal or contrived transactions which have no semblance of business substance. We urge that taxpayer's payments to the insurance company with which he contracted do not become "interest" payments merely because they are so labeled. If, for example, A gives a note to B for $10,000, obligating himself to pay interest at six percent, and B concurrently gives to A a reciprocal note identical in terms and duration, these "wash" transactions do not entitle either A or B to take deductions for "interest." Similarly, here, if taxpayer's obligation to the insurance company was

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case. *Diggs* v. *Commissioner*, decided on July 5, 1960 (60–2 U.S.T.C. ¶ 9584), petition for certiorari pending, No. 355, this Term.

not incurred in return for economic benefits, but was merely a paper transaction to afford him the means of claiming deductions, there is no legitimate basis for an "interest" deduction. This conclusion is unaffected by the fact that the insurance company makes a charge for its services. That the company may have a commercial reason for entering into the transaction from its side will not avail taxpayer if his payments do not constitute compensation for the use of borrowed funds. With these preliminary considerations stated, we turn to an examination of the particular transactions involved.

2. At the end of the taxable year 1953, taxpayer purchased 30-year "annuity savings bonds" from an insurance company in exchange for his 3½% nonrecourse "annuity loan notes" totalling $4,000,000 (plus $4,000 cash). Concurrently, he prepaid $140,000 "interest" on the notes, "borrowed" back $99,000 of the prepaid "interest," and prepaid an additional $3,465 "interest" on the re-borrowed prepaid interest. At the end of 1954 and 1955, taxpayer made similar prepayments of "interest" totalling $147,105 and $150,745, respectively, and again "borrowed" back most of these prepayments in exchange for additional nonrecourse notes. Taxpayer reserved the right to cancel his notes at any time and to receive the then "net cash value" of the annuity bonds, *i.e.*, the excess of their "cash value" over his total note "indebtedness." Since taxpayer's notes bore interest at the rate of 3½% annually, while the cash value of the bonds increased at the rate of only 2½% annually, the "net

cash value" of the bonds was always less than his "interest" payments on the notes, the difference being retainable by the insurance company as its profit from the transaction. In 1956, after the Commissioner had disallowed deductions for interest, taxpayer elected to surrender the annuity bonds in exchange for cancellation of his then outstanding note "indebtedness" to the company totalling $4,307,000 (plus $1,000 cash). He did not enter into the transaction for profit, nor did he stand to derive (tax saving apart) any economic benefit from it. On the contrary, upon termination of the transaction, taxpayer admittedly was out of pocket in the amount of $137,315 (total "prepayments of interest," plus down payment of $4,000, less total amounts "borrowed"). His sole objective was to secure a deduction of the prepaid "interest" from his taxable income, as claimed in his returns, and to obtain annually a tax saving greater than his net payments to the insurance company.

On the basis of these facts, the courts below correctly concluded that the so-called interest payments did not qualify for deduction as "interest * * * on indebtedness" within the meaning of the taxing statute. The record shows, as both courts below found, that the payments did not represent consideration for the use of borrowed funds. Indeed, no money was actually advanced to the taxpayer. He merely contracted to pay stipulated annual amounts (labeled "interest"), in return for which the insurance company agreed to pay him the "net cash value" of the bonds. The net cash value, in turn, represented the aggregate of the so-called interest payments less the company's

fees or charges. Only the insurance company could profit from the arrangement; so far as the taxpayer was concerned, it was devoid of economic substance and had no insurance features. The so-called interest payments in reality represented nothing more than the price of hoped-for tax benefits which would more than offset the net payments.

In cases which are indistinguishable on their facts, the Second and Third Circuits have reached the same result, although the Fifth Circuit, in a divided decision, has held to the contrary. In still other cases which are fairly analogous, the federal courts generally have denied claims to an "interest" deduction.

3. There is no merit to taxpayer's contention that the claimed interest deductions must be allowed under 1939 Code Section 23(b) because they are not specifically barred by Section 24(a)(6) and corresponding provisions of the 1954 Code. The claimed deduction must meet the test established by the "allowance" provision, irrespective of whether it also falls under an express prohibition. Section 24(a)(6) prohibits the deduction of designated classes of interest payments "in any case," *i.e.*, even though true interest is paid and would *otherwise* be deductible under Section 23(b). It does not affirmatively authorize, or purport to authorize, any deduction. Where, as here, the alleged payments do not qualify for deduction in the first instance, the disqualification provisions do not come into play.

Taxpayer also contends, in similar vein, that the payments in question should be deemed deductible

under 1939 Code Section 23(b) because interest on indebtedness incurred to purchase single-premium annuity contracts was specifically barred as a deduction for the first time by Section 264 of the 1954 Code. But the initial question under both Codes is whether the payments qualified for deduction as "interest" within the meaning of the allowance section—not whether, if they otherwise qualified, their deduction would nevertheless be precluded by an express prohibition.

Contrary to taxpayer's assumption, the legislative history of Section 264 of the 1954 Code does not show that Congress considered all alleged interest payments under single-premium annuity contracts to be deductible under the 1939 Code, irrespective of whether they represented *bona fide* "interest" on indebtedness as that term had been construed by the courts. But even if that assumption were correct, it would not follow that the deliberations of the Congress which enacted the 1954 Code establish the purpose of the Congress which enacted the 1939 Code. As this Court recently stated, "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." *United States* v. *Price,* 361 U.S. 304, 313. Nor may the Treasury's request for legislation adding interest payments under single-premium annuity contracts to the categories of specifically prohibited deductions be viewed as an admission that *sham* interest payments of the kind here involved were previously deductible. On the contrary, the Service had issued an administrative ruling that

such payments were non-deductible (Rev. Rul. 54–94, 1954–1 Cum. Bull. 53), and the courts had not yet passed upon the question. The Treasury's request was thus aimed at reinforcing the administrative interpretation of existing law and removing any doubt as to the future.

4. The briefs *amici curiae* fail to meet the issue presented.

(a) Granting that the transaction was a valid and enforceable annuity contract under state law, entered into with a duly chartered insurance company, the payments in question must nevertheless qualify for deduction under the federal taxing statute as true "interest." Whatever the legal effect of the arrangement for local law purposes, either as to the insurance company or the taxpayer, it is ineffectual to alter taxpayer's federal income tax liability since the payments were not made for the use of borrowed funds.

(b) The contention that the Commissioner was estopped from applying Rev. Rul. 54–94 retroactively, by reason of the taxpayer's reliance upon prior inconsistent rulings, is addressed to an issue not here presented. The prior rulings to which reference is made were individual, unpublished letter rulings addressed to other taxpayers. The instant taxpayer has neither alleged nor shown that he relied upon those rulings. Moreover, even the persons to whom the letters were addressed could not complain of a retroactive revocation correcting a mistake of law. *Automobile Club* v. *Commissioner*, 353 U.S. 180.

It is argued further, however, that the rule of the

Automobile Club case is inapplicable because the Commissioner is not applying his corrective ruling (Rev. Rul. 54–94) uniformly. It is said, in this connection, that persons who received the letter rulings are being allowed to deduct interest payments made under the contracts which they executed. This assertion is in error. The fact is that such persons are being allowed partial relief in the form of a loss deduction for net out-of-pocket loss resulting from investment in the particular annuity scheme. This is not inappropriate inasmuch as the individual recipient of a particular letter ruling has a basis for reliance which is not shared by persons who did not receive such advice. See *Weller* v. *Commissioner*, 270 F. 2d 294 (C. A. 3d). In all events, however, the taxpayer is not before the Court claiming a deduction for the loss suffered on termination of the scheme. This case involves taxpayer's claim for interest deductions during the years that the scheme was in operation. Taxpayer has made a claim for a loss deduction (in his 1956 return) but that claim is not part of this litigation; it is pending administratively before the Commissioner.

5. There is an independent ground (not reached below) for sustaining the Commissioner as to the bulk of the deficiencies in controversy. Even assuming, *arguendo*, that interest is actually involved, the major portion of the purported prepayments of interest were immediately recouped in exchange for taxpayer's notes, and accordingly did not represent cash outlays. A cash-basis taxpayer who simply gives his note for interest, or who has the interest added to the principal

amount of his indebtedness, may not deduct the interest until the taxable year in which it is actually "paid." *Eckert* v. *Burnet*, 283 U.S. 140; cf. *Helvering* v. *Price*, 309 U.S. 409.

ARGUMENT

THE LOWER COURTS CORRECTLY HELD THAT THE CLAIMED INTEREST DEDUCTIONS DID NOT MEET THE REQUIREMENTS OF THE STATUTORY PROVISION AUTHORIZING SUCH DEDUCTIONS, AND HENCE MUST BE DISALLOWED

A. The controlling statutory provision authorizes interest deductions only when, in substance as well as in form, payments are made for the use of money or economic benefits actually advanced

Section 23(b) of the Internal Revenue Code of 1939, *supra*, p. 2, and its successor, Section 163(a) of the 1954 Code, *supra*, p. 3, provide in identical language that, in the computation of net income for federal tax purposes, there shall be allowed as a deduction all "interest paid or accrued within the taxable year on indebtedness." The taxpayer asserts that in 1953 he purchased ten "annuity savings bonds" from the Sam Houston Life Insurance Company with a "loan" of $4,000,000 from Sam Houston, plus his own check for $4,000; and that he made four "prepayments of interest" during 1953 and 1954 on the "loan". The sole issue in this litigation is whether he was entitled to deduct the "prepayments of interest."

In sustaining the Commissioner's disallowance of the claimed deductions, the District Court found that no money or equivalent economic benefits were ac-

tually advanced by Sam Houston to the taxpayer; that, indeed, the disputed transactions were devoid of commercial substance, constituting only an attempt to purchase interest deductions. It concluded that there was not a true "indebtedness" or payments of "interest" thereon, within the meaning of Sections 23(b) and 163(a).[8] (R. 57–60.) The Court of Appeals affirmed the findings and conclusion of the District Court, holding that (R. 112):

> The District Court found, with ample support in the record, that the annuity bonds provided neither profit nor insurance; that they had been purchased solely to obtain a tax benefit; and that the alleged interest was not interest in fact, but the purchase price of a tax deduction.

The appellate court then agreed with the Third Circuit's holding in *Weller* v. *Commissioner*, 270 F. 2d 294, that a taxpayer's investment in such a scheme does not qualify as deductible "interest" within the meaning of the statute.

As the decisions below point out, not every obligation which is valid and enforceable constitutes an "indebtedness" within the meaning of the statute, and not every payment labeled "interest" qualifies for a deduction. The statutory allowance of interest deductions extends only to interest paid in the ordinary and usual sense of the market place, that is, to money actually paid for the use or forbearance of money ac-

[8] Since Section 163(a) of the 1954 Code is, as noted, a reenactment of Section 23(b) of the 1939 Code, without change, all further references in this brief to the provision authorizing interest deductions will be simply to Section 23(b).

tually borrowed, or equivalent economic benefits advanced. *Deputy* v. *DuPont,* 308 U.S. 488; *Equitable Society* v. *Commissioner,* 321 U.S. 560, 564; *Haffenreffer Brewing Co.* v. *Commissioner,* 116 F. 2d 465, 469 (C.A. 1st), certiorari denied, 313 U.S. 567. As this Court held in *Deputy* v. *DuPont, supra,* pp. 497–498:

> Clearly respondent owed an obligation to the Delaware Company. But although an indebtedness is an obligation, an obligation is not necessarily an "indebtedness" within the meaning of § 23(b). Nor are all carrying charges "interest." In *Old Colony R. Co.* v. *Commissioner,* 284 U.S. 552, this Court had before it the meaning of the word "interest" as used in the comparable provision of the 1921 Act (42 Stat. 227). It said, p. 560, "* * * as respects 'interest,' the usual import of the term is the amount which one has contracted to pay for the use of borrowed money." It there rejected the contention that it meant "effective interest" within the theory of accounting or that "Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term." * * *
>
> We likewise refuse to make that assumption here. It is not enough, as urged by respondent, that "interest" or "indebtedness" in their original classical context may have permitted this broader meaning. *We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world "interest on indebtedness" means com-*

pensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense. * * * [Italics supplied.]

The taxpayer, in challenging the decision below, does not come to grips with the central issue, *i.e.*, the affirmative scope of Section 23(b). Instead, he addresses himself almost exclusively to the terms and legislative history of *other* statutory provisions which disallow the deduction of interest payments under specified circumstances. The taxpayer's reliance upon these exclusions is misplaced, for various reasons which we discuss below. At this juncture, it suffices to point out that it does not follow from the fact that a certain type of deduction is not specifically disallowed that it must perforce be allowed, without regard to the scope of the authorizing provision.[4] The dispositive question in the case at bar is whether, irrespective of the forms and labels adopted by the parties, the taxpayer actually borrowed in excess of $4,000,000 from Sam Houston, as he contends, and prepaid interest for the use of the money.

Since the District Court found that taxpayer's only motive in entering into the transaction was to attempt to secure an interest deduction (R. 57–58), we turn, at the outset, to the role of tax-avoidance motives in assessing the tax consequences of a given transaction. Certainly the presence or absence of such motives is not itself conclusive. The courts have not questioned

[4] The *amici curiae* briefs also fail to meet this basic issue. See pp. 42–51, *infra*.

the right of a taxpayer to minimize his taxes by casting his transactions in the most tax-advantageous form; so long as the form reflects an underlying reality, the mere presence of tax considerations does not mean that the transaction is a sham for tax purposes. But where the taxpayer employs only a ritual of forms, without commercial meaning or substance, the tax advantage sought must be denied. *E.g., Higgins* v. *Smith,* 308 U.S. 473; *Griffiths* v. *Commissioner,* 308 U.S. 355; *Commissioner* v. *Court Holding Co.,* 324 U.S. 331. "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." *Commissioner* v. *Court Holding Co., supra,* p. 334. "The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute." *Higgins* v. *Smith, supra,* p. 477.

It is equally well settled that asserted tax benefits must be disallowed if the transaction involved, though it has commercial substance of some sort, is not the kind of transaction at which the legislation is aimed, but, rather, in the language of *Gregory* v. *Helvering,* 293 U.S. 465, 470, is a transaction which "upon its face lies outside the plain intent of the statute." See, also, *Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609; *Bazley* v. *Commissioner,* 331 U.S. 737; *Commissioner* v. *Tower,* 327 U.S. 280, 289; *Gilbert* v. *Commissioner,*

248 F. 2d 399, 406 (C.A. 2d), affirmed after remand, 262 F. 2d 512. It follows that even though the instant transaction may have had commercial substance in so far as the insurance company was concerned, (*i.e.*, because it was obtaining a profit for its services,) the taxpayer must show that, as to him, the substance of the transaction was the creation of a true indebtedness (an actual advancement of money or economic benefits) and a true obligation to pay interest thereon.

B. The lower courts were amply warranted by the record in concluding that the purported prepayments of interest did not, in substance, constitute payments for the use of money or economic benefits, and hence did not qualify for deduction under Section 23(b)

The ten annuity contracts involved (labeled "annuity savings bonds") were issued by Sam Houston to the taxpayer as paid-up policies, on December 11, 1953. On its face, the transaction involved large sums of money. The premiums for the bonds, purportedly paid in full on December 11, totaled $4,004,000; and, according to the heading of the instruments, they would have a so-called guaranteed cash value at full maturity (*i.e.*, 30 years from the date) of $8,388,000, with annuity payments thereafter to the taxpayer of $90,171 per month. However, the taxpayer did not actually pay $4,004,000 in premiums; he made an initial investment of only $4,000. And, as will appear, the transaction was neither designed nor carried out in a manner calculated to yield annuity benefits to the taxpayer—much less annuity payments

of $90,171 per month. The true objective of the transaction—the sole benefit or gain of consequence which the taxpayer could hope to realize from his investment—lay in the claimed interest deductions. Those deductions were properly disallowed for a number of reasons, any one of which would be dispositive.

In the first place, it will be evident that Sam Houston did not advance or lend $4,000,000 to the taxpayer on December 11, 1953. Under the terms of the annuity bonds and the loan notes—concurrently issued and executed as integrated instruments—Sam Houston simply debited the taxpayer for a "loan" of $4,000,000, and simultaneously *credited* him with payment of $4,000,000 in premiums (plus the taxpayer's cash investment of $4,000) as payment in full for the bonds. The sole security for the "loan" was the bonds themselves; and, under the terms of the loan notes, the principal amounts thereof would not become due and payable until the annuities became due and payable. Thus, the parties created reciprocal and offsetting future obligations, each commencing at the same time and each ripening at the same time, with the taxpayer expressly exempted from personal liability for the "loan."

This is unlike the situation where a policyholder pays premiums on an insurance policy over an appreciable period of time, and then borrows the cash value from the insurance company on the security of the policy. In such a case, the company has, in the interim, realized earnings on the premiums received and invested; the policyholder thereafter actually borrows the company's funds (cash reserves) for his

own use, in an amount less than the premiums paid in; and this amount is geared on the one hand to the company's earnings on the premiums paid in, and on the other to its expenses, or loading charges.

In the case at bar, by contrast, the taxpayer borrowed nothing earned by and belonging to the insurance company for his own use. Sam Houston did not advance money or its equivalent in immediate economic benefits. There was simply a paper transaction setting up reciprocal future obligations.

Equally distinguishable are situations where the seller of property takes a purchase money mortgage for a part of the purchase price. True, to the extent of such a mortgage, no money actually changes hands; but the buyer has received immediate economic benefits, in the form of possession and use of the property, which are advanced to him in the same manner, and with the same effect, as if he had borrowed money. In the instant case, the taxpayer did not receive any immediate economic benefits when he purchased the bonds, since the "loan" represented and exhausted the immediate cash value of the bonds, and since—as will appear—no real annuity or insurance values were prospectively acquired by the taxpayer.

In short, while the "loan" may have represented a perfectly valid and enforceable obligation under local law, it did not reflect the advancement to the taxpayer of any money or property owned by Sam Houston, but only reciprocal paper obligations. If the taxpayer were to enter into an arrangement with another individual whereby they concurrently "loaned" each other identical amounts of money, at interest, the reciprocal

obligations might be enforceable, but surely neither could deduct payments of "interest" thereon, for federal tax purposes. Not every enforceable obligation represents an "indebtedness" under Section 23(b); there must be a "loan" in fact as well as in name. *Deputy* v. *DuPont, supra; Haffenreffer Brewing Co.* v. *Commissioner, supra.*

Secondly, as the courts below found (R. 57–59, 112), the transaction was devoid of commercial substance; in so far as taxpayer was concerned, it made sense only in terms of contemplated tax benefits. While the taxpayer was obligated to pay "interest" of 3½ per cent per annum, in advance, on the "loan" of $4,000,000 (which represented all but 1/10 of 1 per cent of the cost of the bonds), the cash value of the bonds increased at the rate of only 2½ per cent per annum. Hence the "prepayment" of all premiums at the outset, by means of the "loan," entailed an annual financial loss to the taxpayer of 1 percent of $4,000,000. Nor was this loss mitigated by insurance value accruing under the annuity bonds, as distinct from cash or loan value; as the District Court found (R. 58–59), the bonds contained no insurance element whatever.

The only possible way in which the taxpayer could profit from the scheme was through tax benefits derived from interest deductions. Quite naturally, therefore, the parties adopted a pattern which was designed to give the taxpayer large "interest" deductions wholly unrelated to any true indebtedness or actual investment. In each of the tax years the taxpayer claimed as a deduction the *entire* amounts of the

"prepayments of interest"; but it should be noted that the taxpayer's actual out-of-pocket disbursement was far less, owing to the concurrent augmentations of the "loan." Thus, in December, 1953, the taxpayer made a "down payment" of $4,000, plus two "prepayments of interest" totaling $143,465, a total disbursement of $147,465. But he received back from Sam Houston the sum of $99,000, as an augmentation of the "loan"; hence his net investment in 1953 was $48,465, as against the claimed interest deduction of $143,465. Similarly, in December, 1954, while the taxpayer purportedly made two "prepayments of interest" totaling $147,105, he received back from Sam Houston the sum of $104,000. Thus, in 1954 he actually made a further investment of $43,105, as against the claimed interest deduction of $147,105.

The tax benefits which the taxpayer would have received, had the claimed deductions been allowed, would have far exceeded his actual out-of-pocket investment in Sam Houston, and hence would have converted what was otherwise a losing venture (owing to the overriding 1 per cent interest per annum on the "loan" as periodically augmented) into a source of very substantial gain for both taxable years. Thus, for 1953, having claimed as a deduction his "prepayments of interest" totaling $143,465, the taxpayer reported as net income the amount of $59,290.08; the Commissioner's disallowance of the deduction increased the taxpayer's net income to $202,755.08; and the resulting deficiency in tax (which represents the tax benefits sought) was $113,684.48—as against the taxpayer's net investment for 1953 of $48,465. (R. 13–

14.) Similarly, for 1954, having claimed as a deduction his "prepayments of interest" totaling $147,105, the taxpayer reported as net income $83,123.78; the Commissioner's disallowance of the deduction increased the taxpayer's net income to $230,228.78; and the resulting deficiency in tax (which reflects the tax benefits sought) was $119,613.20, as against the taxpayer's net investment for 1954 of $43,105. (R. 14–15.)

If the taxpayer had been allowed to deduct his "prepayments of interest," it will be evident that, so long as he retained the annuity bonds and continued to enjoy a large income which put him in a high tax bracket, he would continue to enjoy substantial tax benefits each year. Indeed, as the taxpayer concedes (Br. 25), he would have received a tax benefit for 1955, the last full year he held the bonds, if his claimed interest deduction for that year had been allowed. Over the 30-year term of the annuities, such tax benefits would mount to very high totals indeed. In fact, however, the taxpayer held the bonds for only three years, surrendering them in 1956. The reason for this early disposition is apparent. The taxpayer was apprised in June, 1956, by notice of deficiencies, that the Commissioner was disallowing his claimed interest deductions for 1953 and 1954. (R. 11.) The taxpayer surrendered the annuity bonds for cancellation six months later, on December 27, 1956 (R. 40); and, in his return for 1956, he claimed a "loss" deduction in the sum of $136,315, which represented his net "prepayments of interest" for 1953–1955 (plus his original cash outlay of $4,000). This,

taxpayer designated as a loss realized upon the closing-out of the transaction (R. 41). Obviously, the only theory upon which the taxpayer could have claimed such a loss deduction was that the disallowance of his claimed interest deductions for 1953–1955 had effectively deprived him of such deductions. In short, the surrender of the policies and the subsequent return for 1956 reflect a decision on the part of the taxpayer that it was no longer worthwhile to retain the annuity bonds in the light of the Commissioner's disallowance of his claimed interest deductions.

The taxpayer denies that the disputed transaction was a tax device. But his argument in this connection takes a curious form. Insisting that the transaction must be evaluated in its entirety, from the purchase of the bonds in 1953 to their surrender in 1956, the taxpayer argues that, even if his claimed interest deductions for 1953–1955 had been allowed, the tax benefits flowing therefrom would have been less than the loss sustained on surrender of the annuities. On the other hand, assuming the disallowance of the claimed interest deductions, he abides by the claim in his 1956 return that he sustained a loss on surrender of the bonds in the amount of $138,315.[5] In effect, then, the taxpayer is contending that he was doomed to sustain a large out-of-pocket loss in the transaction in any event, whether the claimed interest

[5] The taxpayer recognizes on brief that the figure given in his 1956 return should have been $137,315; that is, that the figure of $138,315 should have been reduced by the amount of $1,000 which he received from Sam Houston on cancellation of the bonds. (Br. 25; cf. R. 41–42.)

deductions were allowed or whether they were disallowed. Hence, he insists that he could not possibly have had a "tax avoidance motive" in purchasing the bonds. (Br. 23–26.)

This line of argument is unsound on many counts. In the first place, it is incredible that the taxpayer would knowingly enter into a transaction which was designed to leave him the poorer no matter how it was concluded and no matter what the tax treatment. This requires the assumption that the taxpayer had no intention or expectation of realizing a profit, either before or after giving effect to his claimed deductions. Furthermore, the record belies his argument. If the claimed interest deductions had been allowed, as we have seen, the taxpayer would have annually enjoyed substantial tax benefits exceeding his net cash outlay. The taxpayer surrendered the bonds in 1956, within three years of their purchase, only because the claimed interest deductions were *disallowed*. Taxpayer does not deny that if the interest deductions had been allowed and the arrangement continued in effect until taxpayer's death, the net effect (assuming taxpayer continued in high income tax brackets) would be the realization of very large tax savings, far exceeding the cost of floating the scheme.

Clearly, the taxpayer did not enter into the disputed transaction in order to purchase annuity benefits, but solely in order to purchase tax benefits. The so-called guaranteed cash value at maturity of $8,388,000, with monthly annuity payments thereafter of $90,171, were fictitious "table" values from the outset, which the taxpayer never intended or expected to

realize. Having exhausted the initial "cash value" of the bonds immediately upon their issuance with the "loan" of $4,000,000, and having in each succeeding year adopted a pattern of augmenting the "loan" to the full amount of that year's cash or loan value (less a nominal $1,000),* the taxpayer stood to realize virtually nothing in annuity benefits. As the District Court found (R. 42), if the taxpayer had continued to hold the bonds to full maturity (that is, until he was 90 years of age), and had continued to execute loan notes each year for the total net cash value of the bonds minus $1,000, he would have received at age 90 an annuity of only $43 a month. It will not be seriously suggested that taxpayer was making net investments upwards of $40,000 per year (see *supra*, p. 26) to receive this pittance at age 90.

The inescapable conclusion, as both courts below found (R. 57–59, 112), is that the transaction was a

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*As appears from the table of cash or loan values in the bonds (*e.g.*, Exhibit 3, Appendix A, *infra*, p. 65), the ten bonds would have a loan value of $4,100,000 at the end of the first contract year, and of $4,204,000 at the end of the second contract year. The taxpayer's original "loan" from Sam Houston was augmented during the first contract year by $99,000 (to $4,099,000), and during the second year by $104,000 (to $4,203,000). (R. 38–39, 57.)

The issuance of the bonds for a nominal cash payment and a "loan" for the balance of the stated consideration would seem to be incompatible with the provisions of each annuity bond (Exhibit 3, Appendix A, *infra*, pp. 64–65) that (par. 11): "The loan may be for an amount not exceeding the cash or loan value * * * for the end of the current Contract year;" and that (par. 12): "This Contract shall have no Cash Value prior to the end of the first Contract year."

tax device, devoid of commercial substance. Sam Houston did not actually advance $4,000,000 to the taxpayer, or immediate economic benefits of any kind; it simultaneously credited and debited him with $4,000,000 (as payment of "premiums" versus nonrecourse "loan"), and then reimbursed him for the major portions of his "prepayments of interest," leaving him with the net investment set forth above. That investment made no commercial sense, since the "interest" the taxpayer had to pay on the "loan" was higher than the increment in "cash value" of the annuity bonds. Only if the entire amounts of the "prepayments of interest" were deductible would the taxpayer realize a benefit. And such a tax benefit, if allowed, would not only offset the taxpayer's net investment—thus, in effect, purchasing the annuity bonds for him—but would far exceed such investment.

The same conclusion, on similar facts, has recently been reached by the Third Circuit in *Weller* v. *Commissioner* and *Emmons* v. *Commissioner,* decided together, 270 F. 2d 294, affirming the Tax Court's decisions in those cases (31 T.C. 33 and 31 T.C. 26).[1] The

[1] In its *Emmons* decision, affirmed by the Third Circuit, the Tax Court succinctly characterized the transaction as follows (31 T.C. at 31):

"* * * The real payment here was not the alleged interest; it was the net consideration, i.e., the first year's premium plus the advance payment of future premiums plus the purported interest, less the 'cash or loan' value of the policy. And the benefit sought was not an annuity contract, but rather a tax deduction of that part of the gross outlay designated for that purpose as 'interest.' Petitioner did not seek an annuity, and in fact gave up all substantial rights of an annuitant in order to reach his true goal, deductions in an amount large enough to reduce his

court below having expressed its "agreement with the opinion" in *Weller*, a copy of that opinion is set forth as Appendix B, *infra*, pp. 75–86. Also in accord is the Second Circuit in *Diggs* v. *Commissioner*, decided on July 5, 1960 (60–2 U.S.T.C. ¶ 9584), petition for certiorari pending, No. 355, this Term, also affirming the Tax Court. And see Rev. Rul. 54–94, 1954–1 Cum. Bull. 53.[8] The Fifth Circuit reached an opposite conclusion in *United States* v. *Bond*, 258 F. 2d 577, a decision which we believe was erroneous for the reasons stated in the dissenting opinion of Judge Wisdom (p. 584). The Third Circuit in *Weller* and *Emmons* (270 F. 2d at 299) expressly concurred in the views stated in that dissent.

Additional support for the Commissioner's position is provided by recent decisions in the analogous cases of *Lynch* v. *Commissioner*, 273 F. 2d 867 (C.A. 2d); *Broome* v. *United States*, 170 F. Supp. 613 (C. Cls.); *Goodstein* v. *Commissioner*, 267 F. 2d 127 (C.A. 1st); and *Sonnabend* v. *Commissioner*, 267 F. 2d 319 (C.A. 1st). Those cases involved the purported "purchase" of millions of dollars worth of short-term Treasury notes, by means of a "loan" on the collateral security

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taxes in a sum greater than the net consideration or cost to him of the entire operation.

"We might well characterize petitioner's activities here as an operation having no business or annuity or borrowing purpose—a mere device which put on the form of a loan as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to borrow money (or purchase an annuity) but to create a deduction for income tax purposes."

[8] This ruling appears in Appendix A to the taxpayer's brief.

of the very Treasury notes which the taxpayers were supposedly purchasing. In each case the "loan" was purportedly secured from a finance company working in concert with the broker handling the "purchase," and the taxpayer undertook to pay the finance company a higher per cent of "interest" on the "loan" than the percentage of interest earned by the Treasury notes. Hence the transaction did not make economic sense, apart from the "interest" deductions claimed by the taxpayer. Moreover, the taxpayer was not really out-of-pocket to the extent of his "prepayments of interest" on the "loan," because he concurrently secured a new "loan" from the finance company every time he made a "prepayment of interest." In all of these cases, the courts have held that there was no commercial substance to the transaction; that the finance company did not, in reality, lend money to the taxpayers for the purchase of Treasury notes or for any other purpose; and that there was neither a true "indebtedness" nor true "interest" payments. Thus in *Goodstein* v. *Commissioner, supra,* 267 F. 2d at 131, the First Circuit said that—

> there was never in substance either a purchase of the notes by the taxpayer or borrowing of the purchase funds from Seaboard. However, it would seem that these transactions did create a legal relationship between the taxpayer and Seaboard, but it was not one of borrower and lender. Rather the net result of these transactions was the exchange of promises of future performances between the taxpayer and Seaboard.

So, also, in the case at bar, the taxpayer and Sam Houston did not enter into the relationship of borrower and lender; rather, the net result (apart from the taxpayer's annual out-of-pocket cost, which he hoped to recoup many times over through tax benefits) was simply an exchange of promises of future performances. The fundamental conditions of Section 23(b) were accordingly unsatisfied.

C. Since the claimed interest deductions cannot qualify under Section 23(b), which is the provision authorizing such deductions, it is irrelevant that there is no provision in the 1939 or 1954 Code which expressly disallows deductions under the circumstances here presented

As demonstrated above, whatever enforceable future obligations the disputed transaction may have created, it did not involve the payment of "interest" on "indebtedness" within the meaning and intendment of Section 23(b), the provision authorizing interest deductions; indeed, the transaction was wholly devoid of commercial substance, since it was not calculated to generate any benefits save those which would flow from allowance of the claimed interest deductions.

The taxpayer, however, relies heavily upon the argument that the claimed interest deductions must be allowed under Section 23(b)—without regard to the affirmative requirements of that provision, as defined in such cases as *Deputy* v. *DuPont, supra*—in the light of the terms and legislative history of certain statutory exceptions which *disallow* interest deductions under specified circumstances. More particu-

larly, he points out that in the 1939 Code there is a statutory exception (Section 24(a)(6), *supra*, p. 2) which prohibits the deduction of any amount paid on "indebtedness incurred or continued to purchase a single premium life insurance or endowment contract," without referring to annuities; and that, although this exception was later expanded (Section 264(a)(2) of the 1954 Code, *supra*, p. 3) to embrace annuity contracts, its application to such contracts was limited to those purchased after March 1, 1954. Since neither the 1939 Code exception nor the 1954 Code exception is applicable here, the taxpayer urges that the *inapplicability* of these exceptions necessarily imports the *applicability* of Section 23(b) to his "prepayments of interest." (Br. 10–23.)

This approach to the statutory scheme is unsound. In the first place, it is evident that the affirmative reach of the provision authorizing interest deductions can hardly be traced, in any kind of a continuous boundary line, by isolated and specific exceptions. As the Third Circuit said in *Weller* v. *Commissioner*, *supra*, 270 F. 2d at 298:

> The fact that annuity contracts are not covered by this prohibition [Section 24(a)(6) of the 1939 Code] is clear beyond peradventure of a doubt. However, such a showing is far from determinative of the issue in the case, for Section 24(a) applies to specific items that are *not* deductible. The section does not even purport to indicate what items are deductible and, therefore, legislative history indicating that annuity contracts were specifically not included

> therein fails to conclude the issue. Regardless of Section 24(a)(6), the taxpayers' payments must still qualify as interest under Section 23(b) to be deductible.

See, also, the dissenting opinion of Judge Wisdom in *United States v. Bond, supra,* 258 F. 2d at 584.

Taxpayer's argument also fails to take into account the important difference between transactions which are commercially meaningful and those which, like the transaction here involved, employ commercial forms and labels solely to procure tax benefits. One can hardly assume that Section 23(b), or any other provision authorizing tax deductions, was so framed that taxpayers need only employ certain labels to avail themselves of its benefits. Indeed, as noted, Congress intended to limit interest deductions to those situations where interest is actually paid for money actually borrowed. *Deputy* v. *DuPont, supra.* Since, during the taxable years, the revenue laws did not prohibit the deduction of interest paid on annuity loans; it is true, to be sure, that such deductions were allowable to the extent that they reflected genuine interest payments. In the case at bar and similar cases, the claimed interest deductions have been disallowed, not because they related to annuities, but because the transaction upon which they were predicated was devoid of commercial substance. See Rev. Rul. 54-94, 1954-1 Cum-Bull. 53.

When Congress has enacted specific exceptions to Section 23(b), it has acted to bar deductions which would *otherwise* have qualified—*i.e.*, deductions for *genuine* interest payments. Of course, such excep-

tions also provide a summary bar to tax avoidance schemes; but they have done so by categorically excluding transactions of the types described, whether genuine or not, thus obviating any debate over commercial substance and reality. Thus, Section 24(a)(6) of the 1939 Code, *supra*, p. 2, and Section 264(a)(2) of the 1954 Code, *supra*, p. 3, interpose an absolute bar to the deduction of "interest" on specified types of loans, without inquiry as to whether the loan in question reflects money actually borrowed or interest actually paid.[9]

The taxpayer argues that the legislative history of Section 264(a)(2) of the 1954 Code shows that Congress understood, in 1954, that existing law authorized interest deductions under the circumstances of this case. It is true that the relevant reports took the

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[9] Similarly, Section 23(b)(2) of the Revenue Act of 1932, c. 209, 47 Stat. 169, which prohibited the deduction of interest paid "on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity," was applicable whether or not there was a genuine "indebtedness" or geninue payments of "interest" thereon. And when this provision was omitted from the Revenue Act of 1934, c. 277, 48 Stat. 680, the legislative history of the Act makes it clear that the change had nothing to do with any considerations pertaining to commercial substance, or the lack of it, in annuity loans. Rather, the omission of the provision was expressly geared to a change in the manner in which annuity payments were taken into income. S. Rep. No. 558, 73d Cong., 2d Sess., p. 24 (1939–1 Cum. Bull. (Part 2) 586, 604–605).

The legislative history of Section 24(a)(6), added to the 1939 Code in 1942, sheds no light on the intent of Congress in adopting the provision. H. Rep. No. 2333, 77th Cong., 2d Sess., p. 81 (1942–2 Cum. Bull. 372, 434); S. Rep. No. 1631, 77th Cong., 2d Sess., p. 97 (1942–2 Cum. Bull. 504, 578). The legislative history of Section 264(a)(2) of the 1954 Code is discussed *infra*, pp. 37–39.

view that existing law did not deny the deduction of interest on indebtedness incurred to purchase single-premium annuity contracts; and that the reports went on to sketch, as subject to the new prohibition, a transaction wherein an annuity is sold for a nominal cash payment with a loan to cover the balance of the cost, interest being taken as a deduction annually with a tax saving that reduced the real interest cost below the increment in value on the policy. H. Rep. No. 1337, 83d Cong., 2d Sess., p. 31 (3 U.S. Code Cong. & Adm. News (1954) p. 4056); S. Rep. No. 1622, 83d Cong., 2d Sess., p. 38 (3 U.S. Code Cong. & Adm. News (1954) pp. 4668–4669). But the transaction thus outlined in the committee reports is not necessarily devoid of all commercial substance, and is to be contrasted with the transaction described in Rev. Rul. 54–94, *supra*. It does not specify the circumstances under which the "loan" is obtained, much less refer specifically to the kind of reciprocal exchange of offsetting future obligations involved in the case at bar, wherein no money or economic benefits are actually advanced. Nor does the outlined transaction assume an annuity contract which is devoid of insurance features, and which can never have a cash, loan, or maturity value in the taxpayer's hands equal to the amount he has invested. Nor does it envision a situation in which the allowance of the claimed deductions would, as in the case at bar, convert a deliberate commercial loss into a tax benefit and recoup the taxpayer's entire net investment many times over.

It is obvious, of course, that Congress was concerned with what it considered the unwarranted tax

benefits which might be obtained from interest deductions in connection with the purchase of annuity contracts. But this is not to say that Congress understood existing law to allow the use of any tax avoidance scheme to obtain "interest" deductions on "annuity contract loans," irrespective of whether the deductions claimed represented true "interest" as that term had been defined by the courts. Certainly the language of Section 264(a)(2) is addressed to all situations involving annuity loans, not merely to tax avoidance devices. Congress apparently intended to deal broadly with all such situations, so as to preclude possible abuse of the interest deduction privilege, whether or not in a particular case the claimed deduction qualified under Section 23(b). Congress accomplished that objective by laying down an omnibus rule. Significantly, 1939 Code Section 24(a) opens with the "General Rule" that "In computing net income no deduction shall in any case be allowed in respect of" the classes of expenditures thereafter enumerated. Corresponding Section 264(a) of the 1954 Code contains a similar "General Rule", *i.e.*, that "No deduction shall be allowed for" enumerated expenditures.

It need hardly be added that later statutes and their legislative history are far from conclusive in the interpretation of earlier legislation. In *Rainwater* v. *United States*, 356 U.S. 590, 593, this Court dismissed a 1918 amendment as merely the expression of how the 1918 Congress interpreted a statute passed by another Congress many years before. Even more categorically, in *Penn Mutual Co.* v. *Led-*

erer, 252 U.S. 523, 538, this Court said that "no aid could possibly be derived from the legislative history of another act passed nearly six years after the one in question." Again, it has been said that Congress is as likely to be wrong as anyone else, in its interpretation of prior law; and that, in any event, it is for the courts to make the ultimate decision as to the reach of prior law. *Fire Companies Bldg. Corp.* v. *Commissioner,* 54 F. 2d 488, 489 (C.A. 2d), certiorari denied, 286 U.S. 546; *American Exchange Securities Corp.* v. *Helvering,* 74 F. 2d 213 (C.A. 2d). Not infrequently, the courts have rejected the views of Congress, as expressed in committee reports, with respect to existing law. *E.g., Fisher Flouring Mills Co.* v. *United States,* 270 F. 2d 27, 33 (C.A. 9th); *Rodner* v. *United States,* 149 F. Supp. 233, 237 (S.D.N.Y.). This Court has given some weight, in resolving a statutory ambiguity, to subsequent legislation which declares the intent of an earlier law. *Federal Housing Administration* v. *The Darlington, Inc.,* 358 U.S. 84, 90. But it has refused, as appears in *Penn Mutual Co., supra,* and, more recently in the *Rainwater* case, to accord the same weight and dignity to characterizations of prior law set forth in committee reports. See also *United States* v. *United Mine Workers,* 330 U.S. 258, 273–280. In its most recent observation on the subject, this Court has admonished that "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." *United States* v. *Price,* 361 U.S. 304, 313.

Perhaps most pointed is this Court's decision in

Higgins v. *Smith*, 308 U.S. 473, in which the Court stated (pp. 479–480):

> Respondent makes the further point that the passage of § 24(a)(6) of the Revenue Act of 1934 which explicitly forbids any deduction for losses determined by sales to corporations controlled by the taxpayer is convincing proof that the law was formerly otherwise. This does not follow. At most it is evidence that a later Congress construed the 1932 Act to recognize separable taxable identities between the taxpayer and his wholly owned corporation. As the new provision goes much farther than the former decisions in disregarding transfers between members of the family it may well have been passed to extend as well as clarify the existing rule.

As in *Higgins*, Section 264(a)(2) of the 1954 Code "goes much farther than the former decisions" in disallowing interest deductions on annuity loans; as noted, it disallows the deduction of interest paid on annuity loans without regard to the circumstances involved, whereas the claimed deductions in the instant case would be disallowed under the "former decisions" on the narrower grounds that no money was actually borrowed or interest paid, and that the transaction was, in any event, devoid of commercial substance. Hence, in accordance with the reasoning of this Court in *Higgins* v. *Smith, supra*, it does not follow from the enactment of Section 264(a)(2) that existing law allowed interest deductions under the circumstances presented here.

*D. It is immaterial that, under Texas law, the disputed transaction gave rise to valid and enforceable obligations; for federal tax purposes, the issue is whether the payments in question constituted "interest * * * on indebtedness" within the meaning of Section 23(b)*

In the brief filed by Mr. Douglas W. McGregor as *amicus curiae,* it is urged that the transactions between the instant taxpayer and Sam Houston (which is a Texas insurance company) were in full conformity with the insurance laws of Texas, and that under those laws the "loan" to the taxpayer gave rise to a valid and enforceable indebtedness. The contention is that the Government must perforce recognize that an indebtedness enforceable under Texas law is also an "indebtedness" within the meaning of Section 23(b), on which "interest" paid is deductible. But this misconceives the relationship of local law to federal tax law.

The Government has assumed throughout this litigation, as it has in cognate cases involving Sam Houston (*e.g., United States* v. *Bond,* 258 F. 2d 577 (C.A. 5th)), that Sam Houston is an insurance company properly chartered under local law; that Sam Houston issued the "annuity savings bonds" involved, and made the "loan" to the taxpayer, in accordance with local law; and that the "loan" gave rise to an enforceable obligation under local law. However, for the purpose of the *federal* tax laws, local laws are not controlling unless Congress has made them so. It is the function of the federal courts to determine, on a uniform and realistic basis, the

federal tax consequences of the myriad transactions which take place daily throughout the fifty States. This Court observed in *United States* v. *Gilbert Associates*, 345 U.S. 361, 363–364:

> We would not question or presume to say what the nature and effect of a tax proceeding is in New Hampshire. The state is free to give its own interpretation for the purpose of its own internal administration. * * *
>
> The Supreme Court of New Hampshire freely concedes, however, as it must, that the meaning of a federal statute is for this Court to decide. *United States* v. *Security Trust & Savings Bank*, 340 U.S. 47. * * *
>
> A cardinal principle of Congress in its tax scheme is uniformity, so far as may be. * * *

And see *Helvering* v. *Clifford*, 309 U.S. 331; *Lyeth* v. *Hoey*, 305 U.S. 188, 194; *Commissioner* v. *Tower*, 327 U.S. 280; *Better Business Bureau* v. *United States*, 326 U.S. 279, 285, fn. 3; *Keystone Automobile Club* v. *Commissioner*, 181 F. 2d 402 (C.A. 3d).

The principle of uniformity, of course, requires that the tax laws be applied according to the substance rather than the form of a transaction. For example, a promissory note in proper form, enforceable according to its terms under local law, may, for purposes of the federal tax laws, be deemed to represent capital contributions to a corporation, with "interest" paid thereon treated as dividends. *E.g., Talbot Mills* v. *Commissioner*, 146 F. 2d 809 (C.A. 1st), affirmed, 326 U.S. 521; *Matthiessen* v. *Commissioner*, 194 F. 2d 659 (C.A. 2d). By the same token, whether there is a true "indebtedness," and true payments of "in-

terest" thereon, within the meaning and intendment of Section 23(b), are questions which are not foreclosed by the fact that those labels may be sanctioned by local law.

E. The administrative practice of the Commissioner during the taxable years does not require the allowance of the claimed interest deductions

A brief filed by Messrs. Richard H. Appert and Converse Murdoch as *amici curiae* [10] is largely devoted to arguments concerning the administrative practice of the Commissioner under Section 23(b). This brief suggests (pp. 2, 3, 11) that taxpayer Knetsch purchased the "annuity savings bonds" from Sam Houston in reliance upon certain private letter rulings, issued by the Internal Revenue Service to third parties, wherein the Service approved interest deductions under circumstances allegedly similar to those presented in the case at bar. It is then suggested that the Government is precluded from espousing its present position on the merits.

This attempt by *amici* to inject an estoppel issue in the case at bar must fail. The taxpayer himself has never claimed, at any stage of this litigation, that

[10] As noted in their brief (p. 1), Messrs. Appert and Murdoch are, respectively, counsel for the petitioners in *Weller* v. *Commissioner* (No. 20, this Term) and *Emmons* v. *Commissioner* (No. 19, this Term). *Weller* and *Emmons* involve the same problem as to deductibility of purported "prepayments of interest" as is presented in the case at bar. This Court has not acted on the petitions in *Weller* and *Emmons*, and is apparently holding them to await decision in the instant case.

he relied upon private rulings in purchasing the "annuity savings bonds." There is no such claim in his present brief to this Court. Nowhere in the record is there any evidence that the taxpayer relied upon private rulings or, indeed, that he ever saw any.[11]

Nor would there be merit to their argument even if it were germane to the issues framed by the parties to this litigation. In the first place, they err in their assertion that, when the Commissioner's delegate issued certain private letter rulings (all unpublished) which approved the deduction of interest paid on annuity contract loans, he committed the Commissioner to a general administrative approval of interest deductions claimed by any taxpayer on any and all transactions purporting to give rise to an annuity contract loan. The views expressed by the Commissioner in private ruling letters are always expressly confined to the particular facts and to the particular transaction disclosed by the applicant for the ruling. They are written with this particularity so that no one reading them may be misled into construing them as general pronouncements of policy. And, as a settled matter of law, they do not constitute rulings of general applicability. *Amici curiae* cite no author-

[11] In *Weller* and *Emmons*, unlike the instant case, the taxpayers did raise an issue of estoppel, contending not only that their "prepayments of interest" qualified for deduction under Section 23(b), but also that the Commissioner was estopped to argue otherwise by reason of private rulings, issued to strangers to the litigation, which the taxpayers had allegedly seen and relied upon. The Third Circuit properly rejected this secondary contention in *Weller* and *Emmons*, for the cogent reasons set forth in its opinion, Appendix B, *infra*, pp. 83–85.

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ity, and we know of none, which entitles one taxpayer to rely upon an unpublished letter ruling addressed individually to another taxpayer. As this Court said with respect to *published* rulings in *Helvering* v. *N.Y. Trust Co.*, 292 U.S. 455, 468—

> the rulings * * * "have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law." See cautionary notice published in the bulletins containing these rulings.

This warning is even more pertinent where, as here, a taxpayer invokes unpublished letter rulings issued to *other* taxpayers. Hence, as the Third Circuit said in *Weller*, Appendix B, *infra*, p. 84, there is "little substance" in the contention "that anyone who sees a ruling should be allowed to rely on it."

Moreover, the Commissioner may retroactively revoke rulings, even as to the recipient (subject only to certain provisos not relevant here). Section 3791(b) of the 1939 Code, reenacted as Section 7805(b) of the 1954 Code, authorizes the Commissioner (with the approval of the Secretary of the Treasury) to determine "the extent, if any, to which any ruling * * * shall be applied without retroactive effect." Pursuant to this authorization, Treasury Regulations have been promulgated, with the approval of the Secretary, which provide that individual rulings will not *generally* be retroactively revoked as to the particular taxpayers to whom they are issued; but that *other* taxpayers are not entitled to rely on such rulings, *unless* they are published in the Internal Revenue Bulletin;

and that, in any event, all taxpayers are cautioned that each ruling represents a conclusion only as to a particular transaction. Treasury Regulations on Procedural Rules (1954 Code), Section 601.201 (i) (4), (5) and (7).

Thus, as a matter of grace, the Commissioner will generally revoke unpublished individual ruling letters without retroactive effect, so far as the addressees are concerned. But this is a discretionary authority. The full power of the Commissioner to effect a retroactive change of administrative position, where necessary to correct an error of law, has recently been reaffirmed by this Court in *Automobile Club* v. *Commissioner*, 353 U.S. 180. There, the Court sustained the Commissioner's retroactive revocation of rulings—specially directed to the very taxpayer there involved—which had exempted the taxpayer from income taxes as a "club" within provisions corresponding to Section 101(9) of the 1939 Code. The Court said (pp. 183–184):

> The petitioner argues that, in the light of the 1934 and 1938 rulings, the Commissioner was equitably estopped from applying the revocation retroactivity. This argument is without merit. The doctrine of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law.

The Court went on (pp. 185–186) to stress that rulings are not of equal force with Treasury Regulations, which may acquire the force of law through repeated reenactment of a statute, and that the retroactive revocation of the rulings involved was not an abuse of

the Commissioner's discretion since the Commissioner proposed to deal in the same manner with all taxpayers similarly situated. See also *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265–266, fn. 5; *Hackett* v. *Commissioner*, 159 F. 2d 121, 124 (C.A. 1st); and *Merchants Nat. Bank* v. *Commissioner*, 199 F. 2d 657, 659 (C.A. 5th).[12]

The only published ruling of general applicability with respect to the type of transaction involved in the case at bar is Rev. Rul. 54–94, 1954–1 Cum. Bull. 53. This general ruling is obviously retroactive, since it is applicable to all claimed interest deductions without regard to when the underlying "loan" transaction was consummated. In so far as the prior private ruling letters are inconsistent with the Commissioner's position in this litigation, we submit that they embody a mistake of law (for the reasons set forth in the earlier portions of this argument) which the Commissioner could retroactively correct by a ruling of general applicability, *i.e.*, by Rev. Rul. 54–94, *supra*. He may do so even as to taxpayers to whom the ruling letters were issued, under the square holding in *Automobile Club*.

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[12] In the words of the Court in the *P. G. Lake* case, *supra*, pp. 265–266, fn. 5:

"The pre-1946 administrative practice was not reflected in any published ruling or regulation. It therefore will not be presumed to have been known to Congress and incorporated into the law by reenactment. See *Helvering* v. *N.Y. Trust Co.*, 292 U.S. 455, 467–468. Cf. *United States* v. *Leslie Salt Co.*, 350 U.S. 383, 389–397. Moreover, prior administrative practice is always subject to change 'through exercise by the administrative agency of its continuing rule-making power.' See *Helvering* v. *Reynolds*, 313 U.S. 428, 432."

See also *Keystone Automobile Club* v. *Commissioner*, 181 F. 2d 402, 406 (C.A. 3d).

But *amici curiae* argue further that the Commissioner does not propose to deal in the same manner, *i.e.*, retroactively, with all taxpayers similarly situated; and hence that he is, or will be, guilty of an abuse of discretion which cannot be countenanced under *Automobile Club* v. *Commissioner*, *supra*. They base this argument upon a Progress Report of the Subcommittee on Internal Revenue Taxation to the House Committee on Ways and Means, dated April 22, 1957, pp. 191–192, in which, they assert, officials of the Internal Revenue Service stated that Rev. Rul. 54–94, *supra*, would not be applied retroactively to the recipients of the ruling letters.

But, as we have seen, the taxpayer is *not* similarly situated with the recipients of the ruling letters. As the Court recognized in *Helvering* v. *N.Y. Trust Co.*, *supra*, taxpayers generally are not entitled to rely on particular rulings issued to the other taxpayers. Indeed, in virtually every case where the Commissioner undertakes to change his administrative position retroactively, there will be some taxpayers to whom the retroactive change will not and cannot apply, by virtue of the statute of limitations or closing agreements or otherwise. Certainly, the only requirement of *Automobile Club* is that the retroactive change be one of general applicability so far as may be, and subject to amelioration as to the particular recipients of ruling letters, as clearly provided by Treasury Regulations. In sum, as the Third Circuit correctly

concluded in *Weller*, Appendix B, *infra*, p. 85, taxpayers in the situation of taxpayer Karl Knetsch "are entitled to the same treatment as all other taxpayers similarly situated, *i.e.*, without rulings, no more and no less. This the Commissioner has afforded them."

Moreover, *amici curiae* misstate the testimony of the Internal Revenue Service officials (Messrs. Swartz *et al.*) in the Progress Report of the Subcommittee on Internal Revenue Taxation, *supra*.[13] Those officials did not say that the recipients of ruling letters would be exempted entirely from the retroactive effect of Rev. Rul. 54–94, *supra*. Mr. Swartz stated that (p. 192)—

> we would allow them a deduction for the out-of-pocket money they had spent, not the full interest deduction, but the extent to which they had relied on it [the ruling letter] to their detriment. * * * We allowed a deduction to the extent of the net out-of-pocket expense.

[13] Even if the assertions of *amici curiae* were true, the Commissioner would not be precluded by statements of his subordinates from determining the taxpayer's correct tax liability. *Helvering* v. *N.Y. Trust Co.*, *supra*. "Whoever deals with the government does so with notice that no agent can, by neglect or acquiescence, commit it to an erroneous interpretation of the law." *Schafer* v. *Helvering*, 88 F. 2d 317, 320 (C.A. D.C.), affirmed, 299 U.S. 171. Indeed, even if the Commissioner himself had formally allowed the claimed deductions for the very taxable years here involved, he would not have been foreclosed from changing his determination within the statutory period of limitations. *Burnet* v. *Porter*, 283 U.S. 230; *New Jersey Worsted Mills* v. *Gnichtel*, 116 F. 2d 338 (C.A. 3d), certiorari denied, 312 U.S. 709. *A fortiori*, the Commissioner is not barred from disallowing a claimed deduction merely because he erroneously had allowed a similar deduction for another taxpayer on the basis of an individual letter ruling.

In the case at bar, as we have seen, the taxpayer's net out-of-pocket expense, his net investment in Sam Houston, was far less than the claimed deductions for "prepayments of interest." Even if his position were deemed identical with that of recipients of the ruling letters, the Commissioner would allow deduction only of his net out-of-pocket investment in Sam Houston. Taxpayer has indeed claimed (in his 1956 return) a loss deduction based upon his out-of-pocket loss incurred at the time of termination of his contracts with Sam Houston. But that claim is not a part of this case and, whatever its merit, it is obviously discrete from the much larger claim (here involved) predicated upon the payment of "interest" during the period prior to termination.[14]

F. Since the taxpayer is on the cash basis, the claimed interest deductions are not allowable for the independent reason that the so-called interest was not "paid" in the taxable years

There is an independent ground—one which the courts below found it unnecessary to reach—why the taxpayer could not, in any event, be allowed to deduct the full amount of the purported "prepayments of interest." He and his wife filed their returns for 1953 and 1954 on the cash basis. (R. 37). It is settled that a cash-basis taxpayer may deduct only items of expense actually paid in cash, or losses actually sustained, during the taxable year. Thus, if he gives a promissory note to cover expenses or losses, or aug-

[14] The claim advanced by taxpayer in his 1956 return is still pending before the Commissioner.

ments an existing indebtedness by the amount of such items, he has not made the required cash payment. *Helvering* v. *Price,* 309 U.S. 409; *Eckert* v. *Burnet,* 283 U.S. 140. Interest deductions claimed by a cash-basis taxpayer are disallowed if they do not reflect an actual out-of-pocket cash outlay on the part of the taxpayer. *Hart* v. *Commissioner,* 54 F. 2d 848 (C.A. 1st); *Keith* v. *Commissioner,* 139 F. 2d 596 (C.A. 2d); *Jenkins* v. *Bitgood,* 101 F. 2d 17, 19 (C.A. 2d), certiorari denied, 307 U.S. 636; cf. *Helvering* v. *Price, supra.* As stated in *Hart* v. *Commissioner, supra,* p. 852:

> The fact that the American Trust Company stamped the bill for interest "paid" and entered the amount of the petitioner's note as a credit to interest on its books of account does not establish a cash payment entitling the taxpayer to a deduction for interest paid where his return is on a cash basis. * * * A promise to pay is not cash, and a deduction [for] interest is permissible only in the taxable year in which the taxpayer pays cash.

Directly in point is *Keith* v. *Commissioner, supra,* where the taxpayer owed interest on loans he had obtained on life insurance policies. He secured additional loans on the policies at the same time that he purportedly made the interest payments. The court held that the purported interest payments were not deductible, notwithstanding the fact that cash reserves applicable to the policies were diminished by the amount of the additional loans. The court reasoned (139 F. 2d at 597):

> This taxpayer gave nothing but a formal contract obligation in the place of his interest obligations. Such action on his part, like the giving of a note to a creditor in substitution for the latter's claim upon an open account, cannot be regarded as the equivalent of a payment in cash. * * *
>
> The taxpayer seeks to establish that there has been a "constructive" payment of the $1,184.21 because the cash reserves applicable to the policies were diminished by the amount of the additional borrowing to pay the interest. But the same contention may be made where there is an additional borrowing from a broker to pay arrears of interest on hypothecated securities. There, as in the case of insurance policies, the borrower's equity is reduced by the amount of the accrued interest. In either case the original amount of interest remains unpaid though secured by the securities or the policies as the case may be. * * *

In the case at bar, as noted, the taxpayer's "prepayments of interest" in 1953 and 1954 were immediately recouped in major part through concurrent augmentation of the taxpayer's "loan" from Sam Houston, and disbursement of the amount of such augmentation from the company to the taxpayer. To the extent of such recoupment, there was a circular routing of cash (or credits) which was meaningless; the net result was simply the augmentation of the taxpayer's purported indebtedness to Sam Houston. Thus, even if there were a true indebtedness here and an obligation on the taxpayer's part to pay interest thereon, to the extent that there was concurrent re-

coupment the purported "prepayments of interest" were non-deductible.[15]

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted.

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SEPTEMBER 1960.

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[15] This was a ground of decision in *Goodstein* v. *Commissioner*, 267 F. 2d 127 (C.A. 1st), where, as noted above (pp. 32–33), there was a similar pattern of "prepayments of interest" which were immediately recouped by the taxpayer.

APPENDIX A

EXHIBIT 3

ANNUITY SAVINGS BOND

OLD LINE LEGAL RESERVE

SAM HOUSTON

Guaranteed Cash Value
$838,800.00
On the Maturity Date

No. A-15403

LIFE INSURANCE COMPANY

Houston, Texas

AGREES TO PAY, subject to the terms and conditions of this Annuity Savings Bond, hereinafter referred to as Contract, at its Home Office in the City of Houston, Texas, to

KARL F. KNETSCH

Herein called the Annuitant, an Annuity of NINE THOUSAND SEVENTEEN---------- Dollars and 10 cents per month, the first such Annuity Payment to be made on the thirtieth anniversary of the effective date of this Contract, which anniversary is hereinafter referred to as the Original Maturity Date, if the Annuitant is then living and this Contract is then in full force, and Annuity Payments of like amount to be made on the same day of each month thereafter, such Annuity Payments terminating with

the last Annuity Payment due preceding the death of the Annuitant, except as hereinafter provided.

It is further expressly agreed that, upon receipt at said Home Office of due proof of the death of the Annuitant occurring after the first Annuity payment has become due and before the sum of the Annuity Payments made by the Company shall amount in the aggregate to the Net Cash Value at the due date of the first Annuity Payment, then in such event the Company guarantees that it will continue the Annuity Payments to the Beneficiary herein designated until the sum of all Annuity Payments made to the Annuitant and said Beneficiary shall in the aggregate equal the Net Cash Value at the due date of the first Annuity Payment, the final payment to be of an amount which together with the sum of all Annuity Payments previously made shall equal the said Net Cash Value. If the Annuitant and the said Beneficiary shall both die before the sum of all the Annuity Payments made by the Company equals the Net Cash Value at the due date of the first Annuity Payment, the then present value of any remaining guaranteed payments, commuted at 2½% interest per annum, compounded annually, shall be paid in one sum to the executors, administrators or assigns of the last to die of the Annuitant and the said Beneficiary.

If the death of the Annuitant occurs while this Contract is in full force and before the due date of the first Annuity Payment provided by the terms of this Contract, the Company will pay, subject to the terms and conditions of this Contract, to EVA FAY KNETSCH, Wife, if living; otherwise, to KARL RAY KNETSCH, Son, WILLIAM H. KNETSCH, Son, SHIRLEY M. KNETSCH FRANCIS, Daughter, DOROTHY V.

KNETSCH CANTIN, Daughter, to share equally, or to SURVIVORS, or SURVIVOR.

(THE BENEFICIARY)

if living at the death of the Annuitant, otherwise to the executors, administrators or assigns of the Annuitant, immediately upon receipt at its Home Office of due proof of the death of the Annuitant and the right of the Claimant to the proceeds, a Death Benefit computed as hereinafter provided.

The Cash Value on the Original Maturity Date of this Contract is EIGHT HUNDRED THIRTY-EIGHT THOUSAND EIGHT HUNDRED--Dollars.

This contract is issued at age 60 in consideration of the application herefor and in further consideration of the payment in advance of a single premium of $400.00 in cash, and the execution of a contract loan agreement for $400,000.00.

The benefits and provisions printed or written on the following pages are a part of this Contract as fully as if they were recited at length over the signatures hereto affixed.

IN WITNESS WHEREOF, Sam Houston Life Insurance Company has caused this Contract to be executed at its Home Office as of the 11th day of December 1953, which is the effective date hereof and the date from which all Contract anniversaries and Contract years shall be computed.

/s/ R. C. Salley
President

/s/ R. R. Bond
Secretary

Single Premium, 30 Year Maturity, Annuity Savings Bond-Deferred Annuity With Optional Maturity Date.

OPTIONAL MATURITY DATE. In lieu of the Annuity otherwise provided by this Contract, the Annuitant may elect, by filing written notice of election with the Company at its Home Office at any time not later than sixty (60) days prior to the anniversary of the effective date of this Contract immediately preceding the Original Maturity Date, to receive an Annuity in an adjusted amount, the first payment to become due on an anniversary of the effective date of this Contract prior to the Original Maturity Date and subsequent to the date of filing written notice of such election (the anniversary thereby elected as the date for the commencement of the Annuity in an adjusted amount being herein called the Optional Maturity Date). The adjusted amount of Annuity payable, provided this Contract is in full force on the Optional Maturity Date, shall be the amount that the Net Cash Value of this Contract at the Optional Maturity Date will provide in accordance with the Table immediately following (the adjusted amount of the Annuity to be determined by the sex and age nearest birthday of the Annuitant on the Optional Maturity Date). Except for the amount of each Annuity Payment and the due date of the first Annuity Payment, the conditions and manner of payment of such Annuity shall be the same as if no election under this provision had been made.

Table showing the amount of monthly annuity payment per $1,000 of net cash value

Age of Nearest Birthday of Annuitant at Date of First Payment		Monthly Payment For Each $1,000 of Net Cash Value	Age of Nearest Birthday of Annuitant at Date of First Payment		Monthly Payment For Each $1,000 of Net Cash Value
Male	Female		Male	Female	
5	10	$2.61	46	51	$3.98
6	11	2.63	47	52	4.04
7	12	2.64	48	53	4.11
8	13	2.66	49	54	4.18
9	14	2.67	50	55	4.26
10	15	2.69	51	56	4.38
11	16	2.71	52	57	4.41
12	17	2.73	53	58	4.50
13	18	2.75	54	59	4.59
14	19	2.77	55	60	4.68
15	20	2.79	56	61	4.77
16	21	2.81	57	62	4.87
17	22	2.83	58	63	4.97
18	23	2.85	59	64	5.08
19	24	2.88	60	65	5.20
20	25	2.90	61	66	5.31
21	26	2.93	62	67	5.44
22	27	2.95	63	68	5.57
23	28	2.98	64	69	5.70
24	29	3.01	65	70	5.85
25	30	3.04	66	71	5.99
26	31	3.07	67	72	6.14
27	32	3.10	68	73	6.31
28	33	3.13	69	74	6.48
29	34	3.17	70	75	6.65
30	35	3.20	71	76	6.84
31	36	3.24	72	77	7.04
32	37	3.28	73	78	7.25
33	38	3.32	74	79	7.46
34	39	3.36	75	80	7.69
35	40	3.40	76	81	7.93
36	41	3.44	77	82	8.18
37	42	3.49	78	83	8.45
38	43	3.53	79	84	8.73
39	44	3.58	80	85	9.02
40	45	3.63	81	86	9.83
41	46	3.68	82	87	9.66
42	47	3.74	83	88	10.00
43	48	3.79	84	89	10.37
44	49	3.85	85	90	10.75
45	50	3.91			

OPTIONAL SINGLE SUM SETTLEMENT.—In lieu of any Annuity otherwise provided by the terms of this Contract, the Annuitant may elect, by surrendering this Contract and filing written notice of election with the

Company at its Home Office within thirty (30) days prior to the date upon which the first Annuity Payment would otherwise become due under the terms of this Contract, to receive in a single sum the Net Cash Value of this Contract at that date, provided this Contract is in full force at that date. Any such election shall take effect on the date upon which the first Annuity Payment would otherwise become due under the terms of this Contract, if the Annuitant is then living, and in such event, the Annuity Payments will not be made.

AMOUNT PAYABLE UPON THE DEATH OF THE ANNUITANT BEFORE THE FIRST ANNUITY PAYMENT BECOMES DUE.—In the event of the death of the Annuitant prior to said Maturity Date, the Company, upon receipt of due proof of the death of the Annuitant will pay to the Beneficiary, if living, otherwise to the Administrators, executors or assigns of the Annuitant, a sum equal to the cash payment made by the Annuitant, excluding any portion of the premium paid by a Contract Loan Agreement, upon delivery of this Contract, but in no event a sum less than the Cash Value of this Contract, less any indebtedness hereon, in full settlement of this Contract.

GENERAL PROVISIONS AND CONDITIONS

1. WHEN EFFECTIVE. This Contract shall not be deemed to be in force nor shall the Company be liable hereunder until this Contract is manually received by the Annuitant during the Annuitant's lifetime and full settlement made for the premium called for on the first page of this Contract; then upon such delivery it shall become effective as of the effective date of the Contract.

2. CONTROL. During the lifetime of the Annuitant, the right to receive all cash values, loans, and other

benefits belonging to this Contract to use all of its options and privileges, and to agree with the Company to any change in or addition to it shall rest alone in the Annuitant, subject, however, to any assignment.

3. CHANGE OF BENEFICIARY. The Beneficiary may be changed as often as desired, subject to the rights of any assignee, by filing a written request, with this Contract for endorsement, at the Home Office of the Company. Such change will take effect on the endorsement of this Contract by the Company and not before. If no Beneficiary hereunder be living at the death of the Annuitant, the proceeds of this Contract will be paid to the executors, administrators, or assigns of the Annuitant, unless otherwise provided herein. If there be more than one Beneficiary, the interest of any deceased Beneficiary shall pass to the survivor or survivors unless otherwise directed by the Annuitant and endorsed by the Company on this Contract.

4. ASSIGNMENT. This Contract may be assigned by the Annuitant, but no such assignment shall be binding upon the Company until a duplicate copy of it has been filed at the Home Office. The Company shall not be responsible for the validity of any assignment, and any claim by an assignee shall be subject to proof of assignment and extent thereof. Any indebtedness to the Company against this Contract shall always be a superior lien over the rights of any assignee whether the Company's indebtedness be created before or after the assignment.

5. CONTRACT. This Contract, or this Contract and the application therefor, if a copy of the application be attached to this Contract when issued, shall constitute the entire contract between the parties. All statements made by the Annuitant shall, in the absence of fraud, be deemed representations and not warran-

ties and no such statement shall be used in defense of a claim under this Contract unless it is contained in the written application. This Contract shall be incontestable after two years from its effective date, except for non-payment of premiums.

6. MISSTATEMENT OF AGE OR SEX. If the age or sex of the Annuitant be misstated, the Annuity Payments hereunder shall be adjusted to correspond with the Annuity Payments that the premiums actually paid would have purchased at the correct age and sex of the Annuitant according to the Company's published rates at the date of this Contract. In the event of any Annuity overpayments or underpayments prior to the date of discovery of the misstatement of the Annuitant's age or sex, such overpayments with interest on each at the rate of 2½% per annum, compounded annually, shall be immediately payable to the Company, and any underpayments of benefits shall, together with interest on each at the rate of 2½% per annum, compounded annually, be paid in one sum to the Payee, as the case may be.

7. MODIFICATION. No alteration or modification of this Contract will be valid unless endorsed hereon by the President, Vice-President, Secretary or Assistant Secretary of the Company. No agent is authorized to waive or modify any terms or conditions of this Contract, to extend the time for payment of premiums, or bind the Company by making any promises not contained in this Contract or by accepting any representations not contained in the written application for this Contract.

8. EVIDENCE THAT PAYEE IS LIVING. The Company, prior to making any Annuity Payments hereunder, may require satisfactory evidence that the Payee is alive and in case request is made for such proof, said payment shall not be made or deemed due until such

evidence shall have been received at the Home Office of the Company.

9. PREMIUM AND LOAN INTEREST PAYMENTS. All premiums or loan interest payments, if any, are payable in advance at the Home Office of the Company at Houston, Texas, or may be paid to any duly authorized collector of the Company in exchange for the Company's receipt signed by the President or Secretary of the Company and countersigned by such collector. A grace period of thirty-one days (without interest) will be allowed for the payment of any loan interest, if any, during which period this Contract shall be continued in force. If any loan interest is not paid when due or by the end of the grace period, this Contract will terminate and shall have no value except as otherwise provided for herein.

10. REINSTATEMENT. Provided this Contract shall not have been surrendered for its Net Cash Value, it may, during the lifetime of the Annuitant, be reinstated at any time within five years after the date upon which it terminated and prior to the due date of the first Annuity Payment provided by the terms of this Contract. Any such reinstatement shall be made only upon written application of the Annuitant to the Company at its Home Office and upon payment of all overdue premiums, if any, with interest thereon at the rate of 4% per annum, compounded annually, from their respective due dates to the date of reinstatement, and upon payment or reinstatement of any indebtedness to the Company of this Contract on the date upon which it terminated with interest on such indebtedness at the rate of 4% per annum, compounded annually, from such date to the date of reinstatement. Such indebtedness, together with any unpaid interest thereon to the date of reinstatement,

may be reinstated only if the loan value is sufficient therefor immediately following reinstatement.

11. CASH LOANS. At any time prior to the due date of the first Annuity Payment provided by the terms of this Contract, the Company will make loans on proper assignment of this Contract and on its sole security. The loan may be for an amount not exceeding the cash or loan value (shown herein in the Table of Cash or Loan Values) for the end of the current Contract year. All existing indebtedness on this Contract and any unpaid premiums for the balance of the current Contract year shall be deducted from the loan. Interest shall be payable in advance to the end of the current contract year and annually in advance thereafter. The rate of interest shall not exceed 3½% per annum. The Company shall have the right to defer making any loan for a period not exceeding ninety days.

If interest is not paid when due, it shall be added to the existing loan provided the total indebtedness on the Contract will not be more than its loan value. The indebtedness thus created shall bear interest at the same rate. The whole or any part of the loan may be repaid at any time prior to the death of the Annuitant and the due date of the first Annuity Payment provided by the terms of this Contract except that such loan may not be repaid after five years following the date of termination of this Contract. Failure to repay any indebtedness or to pay interest shall terminate this Contract when the total indebtedness equals or exceeds the cash value of this Contract.

12. CASH VALUE. At the end of each Contract year prior to the due date of the first Annuity Payment provided by the terms of this Contract, if premiums have been paid in full and this Contract is in full force, this Contract shall have a Cash Value. The

Cash Value at the end of any such Contract year shall be computed in accordance with the Basis of Computation stated in the following TABLE OF CASH OR LOAN VALUES. The Cash value at any date within a Contract year after the first shall be the Cash Value at the end of such Contract year, less interest thereon at the effective rate of 2½% per annum from said date to the end of such Contract year. This Contract shall have no Cash Value prior to the end of the first Contract year.

TABLE OF CASH OR LOAN VALUES

BASIS OF COMPUTATION. The Cash Values shown in this Table are for the end of the Contract years stated and are for a premium unit of $1,001.00. As this Contract is based on –400– premium units, each as specified and described in the preceding sentence, the Cash Values hereunder are –400– times the Cash Values shown in this Table. The Cash Value per premium unit, specified and described in the first sentence of this paragraph, at the end of any Contract year is equal to the then reserve, taken to the nearest dollar, for each such premium unit.

Cash Values at the End of the Contract Years Indicated per $1,000.00 of Total Premium					
End of Contract Year	Cash or Loan Value	End of Contract Year	Cash or Loan Value	End of Contract Year	Cash or Loan Value
1	$1,025	11	$1,312	21	$1,680
2	1,051	12	1,345	22	1,722
3	1,077	13	1,379	23	1,765
4	1,104	14	1,413	24	1,809
5	1,131	15	1,448	25	1,854
6	1,160	16	1,485	26	1,900
7	1,189	17	1,522	27	1,948
8	1,218	18	1,560	28	1,996
9	1,249	19	1,599	29	2,046
10	1,280	20	1,639	30	2,097

13. RESERVE BASIS. The reserve for which funds are to be held upon this Contract shall be calculated on the basis of 2½% interest, compounded annually, prior to the due date of the first Annuity Payment provided by the terms of this Contract, by a net premium method, the formula for which is on file with the Board of Insurance Commissioners of the State of Texas; and the 1937 Standard Annuity Mortality Table with 2½% interest after the commencement of Annuity Payments hereunder.

14. NET CASH VALUE. The words "Net Cash Value" wherever used in this Contract shall mean the Cash Value of this Contract (determined in accordance with the provision entitled "Cash Value") on the date as of which it is being computed and decreased by the amount of any indebtedness to the Company against this Contract.

15. SURRENDER FOR NET CASH VALUE. While this Contract is in force, at any time after one year from the effective date of this Contract and prior to the due date of the first Annuity Payment provided by the terms of this Contract, the Annuitant may surrender this Contract at the Home Office of the Company for its then Net Cash Value. The Company shall have the right to defer payment of the Net Cash Value for a period not exceeding ninety days after receipt of application therefor.

16. ANNUITY PAYMENTS AT ORIGINAL MATURITY DATE. The amount of Annuity Payments specified on the first page of this Contract is based upon the Cash Value on the Original Maturity Date of this Contract, which Cash Value is also specified on the first page of this Contract. If the Net Cash Value of this Contract at the Original Maturity Date is greater or less than the said Cash Value on the Original Maturity Date of this Contract, the amount of

each such Annuity Payment shall be proportionately increased or decreased.

17. INSTALLMENT SETTLEMENT OPTIONS. Provided this Contract is not assigned, upon written request of the Annuitant to the Company at its Home Office, the net proceeds of this Contract payable as a Death Benefit in the event of the death of the Annuitant before the date upon which the first Annuity Payment becomes due hereunder shall be paid to the Beneficiary in accordance with any one or a combination of the Settlement Options provided below or in any other manner upon which the Annuitant and the Company may agree in lieu of the payment of one sum, provided that the Payee is not a firm or corporation. The Beneficiary shall have the same right and privilege if no election effected by the Annuitant is in force when this Contract becomes a claim under the conditions set forth above in this paragraph.

Upon proper release of this Contract and provided it is not assigned, the Annuitant may elect to have the Net Cash Value of this Contract, if this Contract has been in force for not less than one year, paid in accordance with any one or a combination of the Settlement Options provided below, or in any other manner upon which the Annuitant and the Company may agree in lieu of payment in one sum.

Option 1. Proceeds may be left with the Company to accumulate at compound interest for a period not exceeding thirty years. The rate of interest shall be determined from time to time by the Company but in no event shall it be less than 2½% per annum, compounded annually.

Option 2. Proceeds may be left with the Company to be paid in monthly installments of a specified amount until the proceeds so left together with interest thereon at 3% per annum compounded annually,

and such excess interest as may be apportioned by the Company shall have been paid.

Option 3. Proceeds may be left with the Company to be paid in annual installments of a specified amount until the proceeds so left together with interest at 3% per annum, compounded annually, and such excess interest as may be apportioned by the Company, shall have been paid.

Option 4. Proceeds may be applied to the purchase of a life annuity on any one of the forms and at the rates then in current use by the Company.

If the Annuitant has requested that the proceeds of this Contract be paid in installments, no Payee can either assign or commute the unpaid installments unless such right is given in writing by the Annuitant and endorsed on this Contract by the Company during the lifetime of the Annuitant.

In the event of death of the Payee before all of the installments under Options 2 or 3 have been paid, or while any funds are retained under Option 1, the amount of any funds, including accrued interest thereon, then remaining, shall be paid in one sum to the executors, administrators or assigns of the Payee.

The Annuitant may, in writing, and with the written consent of any assignee of record, change or revoke any selections under these options while this Contract is in force and prior to the commencement of any income payment selected, but no selection, change, or revocation shall take effect until endorsed on this Contract by the Company.

When the Proceeds of this Contract become payable under any one of the Installment Settlement Options, it must be surrendered and the Company shall deliver to each Payee a certificate showing the rights and benefits of such Payee or Payees under the Options selected by the Annuitant.

If this Contract is assigned, these modes of settlement shall be available only with the Company's consent.

This policy is assigned to the Company as security for Loan Indebtedness. Particulars may be obtained from the Company, at 3030 Louisiana Street, Houston, Texas.

SAM HOUSTON LIFE INSURANCE COMPANY
By: /s/ ELLA MAYE HRATEK
Assistant Secretary.

Registrar /s/ ELLA MAYE HRATEK

EXHIBIT 13

ANNUITY LOAN NOTE AND ASSIGNMENT OF ANNUITY SAVINGS BOND

IN CONSIDERATION OF the sum of—FOUR HUNDRED THOUSAND ($400,000.00) DOLLARS advanced by SAM HOUSTON LIFE INSURANCE COMPANY of Houston, Texas, which sum the Company is hereby authorized and directed to apply to pay the remaining premiums required by the terms of said Annuity Savings Bond, and receipt whereof is hereby acknowledged, as a loan on the sole security of and in accordance with the provisions contained in Annuity Savings Bond Number A–15404 on the life of KARL F. KNETSCH issued by the said Company, I hereby assign said Annuity Savings Bond and all sums of money now due or hereafter to become due thereunder, including benefits at death, to said Company as security for the repayment of the said loan and interest thereof. Interest shall be payable in advance at the rate and at the time and in the manner provided in the said Annuity Savings Bond. It is agreed that any interest which is not paid when due shall be added to the principal of the loan, and shall become a part thereof

and shall bear interest at the same rate and on the same conditions as the loan.

It is also agreed that the principal of the said loan together with any interest due and accrued thereon shall become due and payable whenever the said Annuity Savings Bond shall become due and payable, or whenever the total indebtedness on said Annuity Savings Bond shall equal or exceed the guaranteed cash value of the said Annuity Savings Bond. If at any time the entire indebtedness evidenced by this loan, together with any other indebtedness on said Annuity Savings Bond, shall equal or exceed the guaranteed cash value of the said Annuity Savings Bond, the Company's liability under the said Annuity Savings Bond shall automatically terminate.

If the said Annuity Savings Bond shall lapse or become forfeited in any manner, the amount of the said loan with any interest accumulated or accrued thereon shall be deducted from any cash surrender value of said Annuity Savings Bond as provided in the Cash Values privilege of said Annuity Savings Bond.

It is expressly represented that all natural persons signing below are of legal age and that no proceedings in bankruptcy or insolvency have been instituted or are pending against any of the undersigned.

It is understood that there is no personal liability upon the makers of this note for the payment thereof, the sole recourse being against the said Annuity Savings Bond.

IN WITNESS WHEREOF, I have hereunto set my hand and seal this Eleventh day of December, 1953.

Witness /s/ MAX KOVEN

/s/ KARL F. KNETSCH

Signature of Owner.

Exhibit 26

Annuity Loan Note and Assignment of Annuity Savings Bond

In Consideration of the sum of—Nine Thousand Nine Hundred ($9,900.00)—Dollars advanced by Sam Houston Life Insurance Company of Houston, Texas, which sum the Company is hereby authorized and directed to apply to pay the remaining premiums required by the terms of said Annuity Savings Bond, and receipt whereof is hereby acknowledged, as a loan on the sole security of and in accordance with the provisions contained in Annuity Savings Bond Number A–15402 on the life of Karl F. Knetsch issued by the said Company, I hereby assign said Annuity Savings Bond and all sums of money now due or hereafter to become due thereunder, including benefits at death, to said Company as security for the repayment of the said loan and interest thereof. Interest shall be payable in advance at the rate and at the time and in the manner provided in the said Annuity Savings Bond. It is agreed that any interest which is not paid when due shall be added to the principal of the loan, and shall become a part thereof and shall bear interest at the same rate and on the same conditions as the loan.

It is also agreed that the principal of the said loan together with any interest due and accrued thereon shall become due and payable whenever the said Annuity Savings Bond shall become due and payable, or whenever the total indebtedness on said Annuity Savings Bond shall equal or exceed the guaranteed cash value of the said Annuity Savings Bond. If at any time the entire indebtedness evidenced by this loan, together with any other indebtedness on said Annuity Savings Bond, shall equal or exceed the guaranteed

cash value of the said Annuity Savings Bond, the Company's liability under the said Annuity Savings Bond shall automatically terminate.

If the said Annuity Savings Bond shall lapse or become forfeited in any manner, the amount of the said loan with any interest accumulated or accrued thereon shall be deducted from any cash surrender value of said Annuity Savings Bond as provided in the Cash Values privilege of said Annuity Savings Bond.

It is expressly represented that all natural persons signing below are of legal age and that no proceedings in bankruptcy or insolvency have been instituted or are pending against any of the undersigned.

It is understood that there is no personal liability upon the makers of this note for the payment thereof, the sole recourse being against the said Annuity Savings Bond.

IN WITNESS WHEREOF, I have hereunto set my hand and seal this 16th day of December, 1953.

[S] KARL F. KNETSCH,
Signature of Owner.

Witness [S] MAX KOVEN

[Stamped across the face of this instrument is the following:

CANCELLED
DATE *December 30, 1954 R. O. Young*]

EXHIBIT 38

ANNUITY LOAN NOTE AND ASSIGNMENT OF ANNUITY

IN CONSIDERATION OF THE SUM OF TWENTY THOUSAND THREE HUNDRED AND NO/100 ($20,300.00) Dollars advanced by SAM HOUSTON LIFE INSURANCE COMPANY, of Houston, Texas, the receipt whereof is hereby acknowledged, as a loan on the sole security of and in

accordance with the provisions contained in Annuity Number A 15402 on the life of KARL F. KNETSCH issued by the said Company, I hereby assign said Annuity and all sums of money now due or hereafter to become due thereunder, including benefits at death, to said Company as security for the repayment of the said loan and interest thereon. Interest shall be payable in advance at the rate of three and one-half (3½%) per cent per annum, and at the time and in the manner provided in the said Annuity. It is agreed that any interest which is not paid when due shall be added to the principal of the loan, and shall become a part thereof and shall bear interest at the same rate and on the same conditions as the loan.

It is also agreed that the principal of the said loan together with any interest due and accrued thereon shall become due and payable whenever the said Annuity shall become due and payable, or whenever the total indebtedness on said Annuity shall equal or exceed the guaranteed cash value of the said Annuity. If at any time the entire indebtedness evidenced by this loan, together with any other indebtedness on said Annuity, shall equal or exceed the guaranteed cash value of the said Annuity, the Company's liability under the said Annuity shall automatically terminate.

If the said Annuity shall lapse or become forfeited in any manner, the amount of the said loan with any interest accumulated or accrued thereon shall be deducted from any cash surrender value as provided in said Annuity.

It is expressly represented that all natural persons signing below are of legal age and that no proceedings in bankruptcy or insolvency have been instituted or are pending against any of the undersigned.

It is understood that there is no personal liability upon the makers of this note for the payment thereof, the sole recourse being against the said Annuity.

IN WITNESS WHEREOF, I have hereunto set my hand and seal this 30th day of December, A.D. 1954.

/s/ R. R. Bond
Witness.

/s/ KARL F. KNETSCH
Signature of Owner.

[Stamped across the face of this instrument is the following:

CANCELLED
DATE *12-28-55 R. O. Young*]

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 12,844

CARL E. WELLER AND EMILY I. WELLER,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 12,854

W. STUART EMMONS,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITIONS FOR REVIEW OF DECISIONS OF THE TAX COURT OF THE UNITED STATES.

Argued June 9, 1959

Before BIGGS, *Chief Judge,* and MCLAUGHLIN and STALEY, *Circuit Judges.*

OPINION OF THE COURT

(Filed September 9, 1959)

By STALEY, *Circuit Judge.*

These cases present identical questions of law,[1] namely, whether the Tax Court erred in holding that certain transactions involving prepayment of interest on annuity contract loans lacked substance so as not to be deductible as interest payments under Section 23(b) of the Internal Revenue Code of 1939.

The essential facts in the *Emmons* case, as found by the Tax Court, may be summarized as follows: Emmons, a cash basis taxpayer, purchased an annual premium annuity policy from Standard Life Insurance Company of Indiana in 1951. The policy required forty-one annual payments of $2,500 each, and the initial premium was paid on December 20, 1951, the date of issuance of the policy. The next day Emmons borrowed on his personal note $59,213.75 from the Girard Trust Corn Exchange Bank, pledging the annuity policy as collateral. This sum was credited to the account of the insurance company as a prepayment, at a discount, of all future premiums on the annuity policy.

On December 24, 1951, Emmons paid an additional $13,627.30 to Standard purportedly as interest to

[1] The cases were tried separately in the Tax Court and argued separately in this court; however, inasmuch as the Tax Court relied on the reasoning in the Emmons case as dispositive of both and as the facts differ in no material particulars, we will consider them together. Cases reported below: W. *Stuart Emmons* v. *Commissioner of Internal Revenue*, 31 T.C. No. 4 (1958) reviewed by full court (Tietjens, J., dissenting without opinion); *Carl E. Weller* v. *Commissioner of Internal Revenue*, 31 T.C. No. 5 (1958).

December 20, 1956, on an anticipated loan and received in return a receipt designating the payment as "Interest on Annuity Loan Contract No. AN-53651 to December 20, 1956." Following this payment the "cash or loan" value of the annuity contract had increased to $68,364. The petitioner received exactly that amount on December 27, 1951, and executed an agreement designated "Annuity Loan Agreement," providing for interest at 4 per cent per annum. That same day Emmons repaid the bank the earlier loan, utilizing part of the proceeds of the annuity loan.

One year later, on December 31, 1952, Emmons paid Standard the additional amount of $9,699.64 and received a receipt indicating the payment was for "Annuity Loan Interest to December 20, 1959." The discount rate for prepayment of interest was 2.85 per cent. Thus, the second prepayment of interest increased the cash or loan value of the annuity contract to $73,728 and the increase of $5,364 was received by the taxpayer on the same day. Upon receipt, Emmons executed a second "Annuity Loan Agreement." At the date of the proceeding in the Tax Court the "loans" had not been repaid.

Emmons deducted the $13,627.30 payment as interest in his income tax return filed for 1951 and the $9,699.64 payment in his 1952 tax return. The Commissioner disallowed both deductions, insisting that (1) no indebtedness arose upon which payments of interest may be predicated, and (2) the payments constituted premiums rather than interest.

In arriving at its decision, which was reviewed by the full court, the Tax Court concluded that, despite the fact that the payments in question were in form interest within the meaning of Section 23(b)

of the Internal Revenue Code of 1939, the entire transaction lacked substance and therefore was to be ignored for tax purposes.

The facts in the Weller case, except for dates and amounts, are practically the same.

Petitioners' attack on the judgments is essentially twofold. They assert that the payments clearly constituted interest within the meaning of Section 23(b) and were therefore deductible under that section. Additionally, they contend that the Commissioner may not, under the circumstances of these cases, retroactively reverse his prior rulings which allowed similar deductions.

Section 23 of the Internal Revenue Code of 1939, "Deductions from gross income," provides for deductions of "All interest paid or accrued within the taxable year on indebtedness * * *." The Supreme Court has defined the term interest as used in the Internal Revenue Code on several occasions. In *Old Colony Railroad Co.* v. *Commissioner of Internal Revenue*, 284 U.S. 552, 560 (1932), it was held to be "the amount which one has contracted to pay for the use of borrowed money." Again, in *Deputy* v. *du-Pont*, 308 U.S. 488, 497–498 (1940), the Court stated that "* * * although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of § 23(b). Nor are all carrying charges 'interest.' * * * We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world 'interest on indebtedness' means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense." Applying these definitions to the instant cases, we come to the crux of the government's case. It contends that since inter-

est for tax purposes is confined to payments for the use of money and since no money or other economic benefit was ever in effect advanced to the taxpayers by the insurance company, the payments were not interest.

The Tax Court, and the government on appeal, rely quite heavily on the pattern of conduct evidenced by the taxpayer and Standard. This pattern, as summarized above, involved prepayments of interest which accelerated the cash or loan value of the policy, concurrent borrowing of the accelerated increase in the cash or loan value, thus immediately recouping a major portion of the purported prepayments of interest. The cycle was completed when the taxpayer claimed deductions on his 1951 and 1952 returns of the entire amounts of each prepayment of interest, although his actual outlay was much less. We agree with the conclusion of the Tax Court that, although in form the payments appear to constitute interest within the meaning of Section 23(b) of the Internal Revenue Code of 1939, the entire transaction lacks substance.

Gregory v. *Helvering*, 293 U.S. 465 (1935), relied upon by the Tax Court, involved the creation of a corporate entity for the purpose of transferring shares of stock to the taxpayer. While recognizing that a real, valid corporate entity was created and that the transaction was within the terms of the statute, the Supreme Court concluded that it was "an elaborate and devious form of conveyance masquerading as a corporate reorganization." The activities were described as "an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a

preconceived plan, not to reorganize a business * * * but to transfer a parcel of corporate shares to the petitioner." The Court there also referred to the rule which excludes from consideration the motive of tax avoidance but determined that it was not pertinent to the situation "because the transaction upon its face lies outside the plain intent of the statute." The question of form versus substance as regards the incidence of taxation has been before the courts on a number of occasions involving numerous differing factual situations. In *Higgins* v. *Smith,* 308 U.S. 473, 476 (1940), it was stated that "If * * * the *Gregory* case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability, it gives support to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration." See *Griffiths* v. *Commissioner of Internal Revenue,* 308 U.S. 355 (1939). In like vein the Supreme Court stated in *Commissioner of Internal Revenue* v. *Court Holding Co.,* 324 U.S. 331, 334 (1945), "The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. * * * To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."

Any case of this nature is beset with difficulties, for in viewing the substance of the entire transaction one

is faced with the rule alluded to above that enjoins us to disregard the motive of tax avoidance. That is not to say that we are confronted with a dilemma. Far from it. The proper resolution of the problem has succinctly been set forth by Judge Learned Hand in *Gilbert* v. *Commissioner of Internal Revenue,* 248 F. 2d 399, 411–412 (C.A. 2, 1957), (dissenting on a procedural matter unrelated to this case),

> "* * * If, however, the taxpayer enters upon a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose. * * * [The Gregory doctrine] covers only those transactions that do not appreciably change the taxpayer's financial position, either beneficially or detrimentally."

Thus, the principle laid down in the Gregory case is not limited to corporate reorganizations, but rather applies to the federal taxing statutes generally. The words of these statutes which describe commercial transactions are to be understood to refer to transactions entered upon for commercial purposes and "not to include transactions entered upon for no other motive but to escape taxation." *Commissioner of Internal Revenue* v. *Transport Trading & Terminal Corp.,* 176 F. 2d 570, 572 (C.A. 2, 1949), cert. denied, 338 U.S. 955 (1950).

The Tax Court could find no independent economic purpose present in the instant cases and thus concluded that the sole purpose was the creation of a tax deduction. The petitioners have gone to great lengths to demonstrate that there was commercial substance to the transactions, over and above the tax benefits, but

we are far from convinced. If one ignores the practice of concurrently borrowing the increased cash or loan value of the contracts built up by prepayments of interest one might find some economic sense in the transactions, other than the hoped for tax deductions. However, given the practice, which is borne out by the records, the fact that there was a 4 per cent interest rate on the loans and a mere 2.85 per cent discount rate on the prepaid interest, and the fact that the loans were non-recourse in nature and were never repaid, the conclusion of the Tax Court is a reasonable one.

Petitioners, on the other hand, point out that the insurance company, which was regularly organized and authorized to issue annuity contracts, and to make loans such as those made here, treated the payments on its books as interest received. The government does not challenge the validity of the labels employed by the insurance company nor does it contest the validity of the transactions under the Indiana insurance law. Rather, it points to the well-settled principle that for the purpose of the federal tax laws, the substance of transactions is to be determined uniformly in relation to the meaning and intendment of the federal laws. *United States* v. *Gilbert Associates, Inc.*, 345 U.S. 361 (1953). A denial of these claimed deductions would represent no attack in any way upon the insurance laws of Indiana or any other state in which Standard operates nor would it characterize it a "sham corporation" issuing "sham policies." That there may be an obligation which is valid under local law is not determinative of whether there is a true indebtedness within the meaning of Section 23(b). See *Haffenreffer Brewing Co.* v. *Commissioner of Internal Revenue*, 116 F. 2d 465 (C.A. 1, 1940), cert. denied, 313 U.S. 567 (1941).

Petitioners also place considerable emphasis upon the provisions and legislative history of Section 24(a)(6) which prohibits deductions for certain specified forms of interest, that is, "any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract * * *." The fact that annuity contracts are not covered by this prohibition is clear beyond peradventure of a doubt. However, such a showing is far from determinative of the issue in the case, for Section 24(a) applies to specific items that are *not* deductible. The section does not even purport to indicate what items are deductible and, therefore, legislative history indicating that annuity contracts were specifically not included therein fails to conclude the issue. Regardless of Section 24(a)(6), the taxpayers' payments must still qualify as interest under Section 23(b) to be deductible.

In disallowing the interest in these cases, the department relied upon Revenue Ruling 54-94, 1954-1 Cum. Bull. 53, which, of course, was issued after the taxable years in question. The petitioners contend that the Commissioner may not retroactively reverse his prior rulings which allowed similar deductions. The prior rulings had not been issued to the petitioners, for they had never requested any but were individual rulings in other cases. These individual rulings had been shown to petitioners by insurance company salesmen prior to the time of the purchase of the annuity contracts. Recognizing that they may not rely on these rulings directly, petitioners maintain that all taxpayers have the right to be treated equally and fairly and since they undoubtedly would have received similar rulings had they applied for them, they are entitled to their benefits. They argue further that the very number of individual rulings

made by the Commissioner[2] established a practice, a course of conduct, and that a retroactive change would be an arbitrary exercise of the authority committed to the Commissioner by Congress.[3]

The first contention has little substance or reason to support it, for it is just another way of stating that anyone who sees a ruling should be allowed to rely on it. Even with respect to rulings *published* in the Internal Revenue Bulletin, the Supreme Court said in *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 468 (1934):

> "* * * The rulings * * * 'have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law.' See cautionary notice published in the bulletins containing these rulings."

Certainly *unpublished* rulings can be given no greater effect.

In support of their second contention that it would be an abuse of discretion for the Commissioner to retroactively change his practice established by a series of individual rulings, taxpayers rely upon *Automobile Club of Michigan* v. *Commissioner of Internal Revenue*, 353 U.S. 180 (1957), and our case of *Lesavoy Foundation* v. *Commissioner of Internal Revenue*, 238

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[2] Although there is no evidence in the record as to the number of such rulings made by the Commissioner, Emmons testified he had been shown seven and Weller six or seven such individualized rulings.

[3] Section 3791(b) provides:

"Retroactivity of Regulations or Rulings—The Secretary, or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect." 53 Stat. 467 (1939), 26 U.S.C.A. I.R.C. 1939, § 3791(b).

F. 2d 589 (C.A. 3, 1956). Reliance upon the *Lesavoy* case is misplaced, for it merely determined that the Commissioner had exceeded his permissible discretion in retroactively withdrawing a ruling issued to a particular taxpayer who had not estopped himself. The Supreme Court in *Automobile Club of Michigan* v. *Commissioner of Internal Revenue, supra,* sets forth the standard which we must apply in questions of this nature. In that case, the petitioner-automobile club had received a ruling of exemption from the Commissioner in 1934 which was reconfirmed in 1938. In 1945, applying a new interpretation of the revenue laws rendered by the General Counsel, the Commissioner revoked this individual ruling and applied his revocation retroactively to tax years 1943 and 1944. The revocations applied to exemptions issued to all automobile clubs and the Supreme Court stated, at page 186, "that the Commissioner, having dealt with petitioner upon the same basis as other automobile clubs, did not abuse his discretion." Similarly in the instant cases, the petitioners have been treated in the same manner as all other taxpayers.

Petitioners contend, however, that although the revenue ruling fails to indicate any limitation on its application, agents of the Treasury have stated to Congress that it does not intend to apply the revenue ruling retroactively to individuals who have previously been issued rulings. We need not determine whether such action if carried out would be an abuse of discretion, for petitioners are not in the same position as those parties who have been issued rulings. They are entitled to the same treatment as all other taxpayers similarly situated, i.e., without rulings, no more and no less. This the Commissioner has afforded them.

Petitioners' further arguments are adequately disposed of by *Automobile Club of Michigan* v. *Commissioner of Internal Revenue, supra.*

We are not unmindful of the decision recently rendered by the Court of Appeals for the Fifth Circuit in a similiar case, *United States* v. *Bond,* 258 F. 2d 577 (1958), which holds contrary to this opinion. We agree, however, with the dissenting opinion of Judge Wisdom in that case. In accord with our opinion are *Haggard* v. *United States,* 59–1 U.S.T.C. ¶ 9299 (D.C. Ariz. 1959); and *Knetsch* v. *United States,* 58–2 U.S.T.C. ¶ 9935 (S.D. Calif. 1958). And see *Goodstein* v. *Commissioner of Internal Revenue,* 267 F. 2d 127 (C.A. 1, 1959); *Sonnabend* v. *Commissioner of Internal Revenue,* 267 F. 2d 319 (C.A. 1, 1959).

The judgments will be affirmed.

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Clerk of the United States Court of Appeals for the Third Circuit.

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